The Southland Corporation Annual Report 1985

Segment Description

Convenience Retailing

The convenience retailing segment includes 7,519 7-Eleven stores, Southland's primary business, as well as five regional distribution centers that support the stores. Other retail operations include Chief Auto Parts, Quik Mart gasoline and mini-convenience stores, and Super-7 high-volume self-serve gasoline outlets.

Southland's International Division includes 3,680 7-Eleven and other small retail units operated by area licensees and affiliates in 11 countries. Sales from these operations are not reported in the Company's total revenues.

Food Processing and Manufacturing

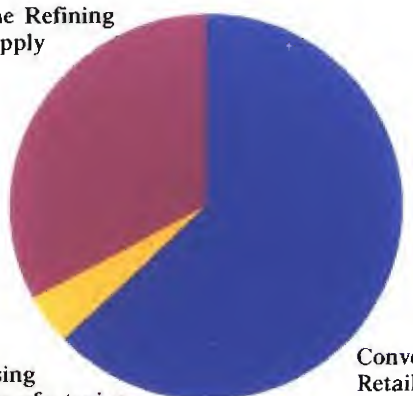
The food processing and manufacturing segment includes Southland Dairies, one of the nation's largest dairy processors, which markets products in all 50 states, the District of Columbia, Canada, Japan and the Caribbean. Its other operations are six food centers, which produce a complete line of sandwiches and other fast foods; El-Ge Potato Chip Division; Pate Foods, a corn-based snack food division; Southland Food Labs, a manufacturer of food ingredients and specialty chemicals; Reddy Ice, the world's largest ice company; and Tidel Systems, a manufacturer of high-security cash-dispensing units and other equipment for retailers.

Gasoline Refining and Supply

The gasoline refining and supply segment is comprised of the refining, marketing and transportation operations of Citgo Petroleum Corporation, which operates a major petroleum products refinery at Lake Charles, Louisiana, and a lubricants compounding plant. Its wholesale marketing business supplies transportation fuels to 3,800 retail gasoline outlets, as well as most 7-Eleven and Quik Mart stores. Citgo has 41 refined product terminals, five of which are jointly owned, as well as various ownership interests in the Cit-Con lubricants refinery at Lake Charles and almost 16,000 miles of refined product and crude oil gathering pipelines.

The Southland Corporation, which in 1927 originated the convenience store concept, operates the largest convenience store chain in the world and is the seventh largest retailer in the United States. Its activities are grouped into three business segments: convenience retailing, food processing and manufacturing, and gasoline refining and supply.

Outside Sales by Segment



Convenience Retailing Segment

7-Eleven	7,519
Other Retail:	
Quik Mart	210
Chief Auto Parts	444
Gristede's	47
Super-7	28
Total Units	8,248
International Affiliates:	
Sweden: 7-Eleven	65
Mexico: Super Siete	46
Total Affiliate Units	111
7-Eleven Area Licensees:	
United States	574
International	2,995
Total Licensee Units	3,569
Total Retail Units	11,928
Distribution Centers	5
Chief Auto Parts Warehouses	2

Food Processing and Manufacturing Segment

Dairies:	
Processing Plants	23
Distribution Points	68
Food Centers	6
Snack Food Plants	2
Reddy Ice Plants	8
Food Labs Plants	3
Tidel Systems Plant	1

Gasoline Refining and Supply Segment

Citgo Refinery	1
Cit-Con Lubricants Refinery*	1
Lubricants Compounding/ Packaging Plant	1
Refined Product Terminals*	41
Pipelines (miles):*	
Crude Oil Gathering	7,646
Refined Product	7,947

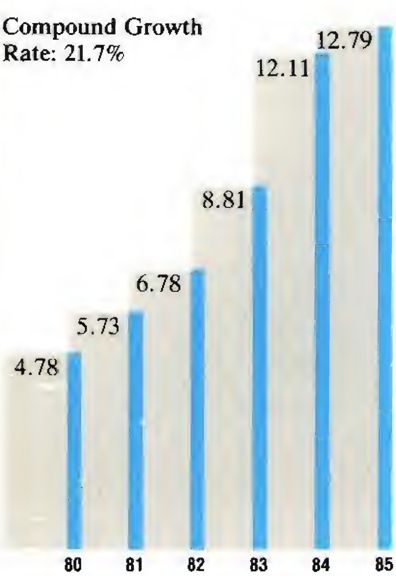
Facility numbers as of December 31, 1985
**Various ownership interests*

Contents

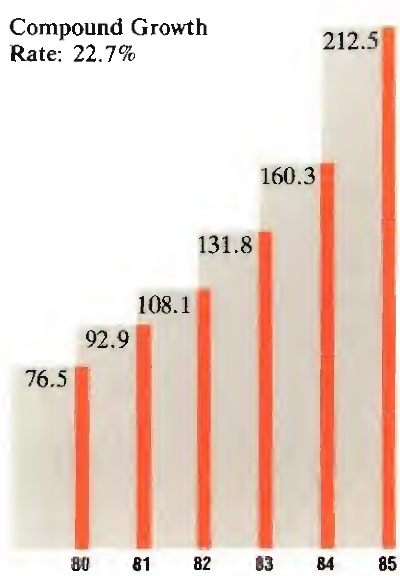
Financial Highlights

(Dollars in thousands, except per-share data)	1985	1984	% Change
		Year ended December 31	
Financial summary			
Total revenues	**$12,789,630**	$12,105,001	5.7
Net earnings	**212,535**	160,252	32.6
Primary earnings per share	**4.41**	3.41	29.3
Fully diluted earnings per share	**4.37**	3.38	29.3
Average shares outstanding — common stock (000s)	**47,400**	46,972	.9
Cash dividends — common stock	**47,405**	43,215	9.7
Cash dividends per share — common stock	**1.00**	.92	8.7
Capital expenditures	**476,063**	431,926	10.2
Return on average shareholders' equity	**16.06%**	14.17%	
Financial condition at year-end			
Total assets	**3,735,544**	3,339,772	11.9
Shareholders' equity	**1,496,823**	1,195,687	25.2
Long-term debt	**686,059**	856,646	(19.9)
Debt-to-equity ratio	**.47**	.74	
Working capital	**208,981**	256,121	(18.4)
Shareholders' equity per share of common stock	**28.84**	25.39	13.6
Number of shareholders of record — common stock	**8,186**	8,927	(8.3)
Number of employees	**63,500**	61,800	2.8

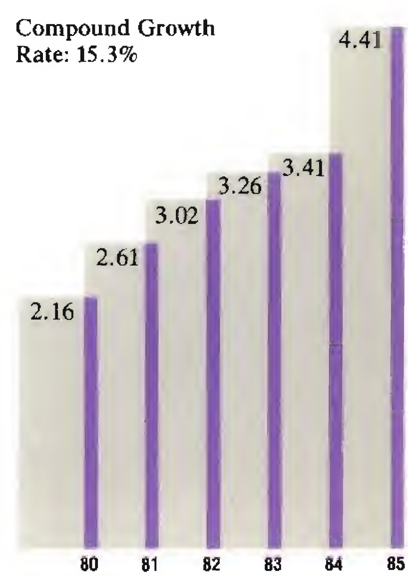
Total Revenues
(Dollars in Billions)



Net Earnings
(Dollars in Millions)



Primary Earnings Per Share
(In Dollars)



Net earnings exceeded $200 million for the first time in the Company's history, increasing 32.6 percent to $212.5 million.

The proposal with Petroleos de Venezuela, S.A. is a unique opportunity to fulfill two important Southland objectives.

One of Southland's key strategies is to continually improve the 7-Eleven store base . . . by building most new stores on corner sites . . . remodeling existing stores on a regular basis . . . closing stores that no longer meet our criteria.

For the 24th consecutive year, Southland achieved record revenues and net earnings in 1985. Net earnings exceeded $200 million for the first time in the Company's history, increasing 32.6 percent to $212.5 million, due mainly to the outstanding performance of Citgo Petroleum Corporation. Revenues of $12.79 billion were up 5.7 percent. Southland's effective tax rate increased to 24.7 percent from 7.0 percent in 1984 because of a 63.8 percent increase in pretax earnings to $282.3 million, even with the tax benefits realized from Citgo. Both primary earnings per share and fully diluted earnings per share increased 29.3 percent to $4.41 and $4.37, respectively.

Southland announced on February 5, 1986, that it had signed a letter of intent outlining the framework for negotiations to sell a 50-percent equity interest in Citgo to a subsidiary of Petroleos de Venezuela, S.A. (PDVSA), Venezuela's state-owned oil company. Under the proposal, PDVSA will pay approximately $290 million for its interest in Citgo and provide its share of Citgo's working capital requirements. It will also deliver a minimum of 130,000 barrels per day of crude and other feedstocks under a long-term supply agreement, with an option to increase supply by another 70,000 barrels per day.

The proposal with PDVSA is a unique opportunity that will fulfill two important Southland objectives. Not only will it help ensure a long-term feedstock supply for a large part of the refinery's needs at prices that reflect market conditions in the United States, but it should also make Citgo less subject to the historically cyclical nature of the refining industry. Although a definitive agreement is not expected until mid-year, the refinery began receiving more than 130,000 barrels per day of crude oil and feedstocks from Venezuela in February under the terms of the letter of intent.

Total sales at 7-Eleven stores in 1985 were up 8.8 percent to $6.98 billion. Merchandise sales increased 8.0 percent, including a 5.9 percent gain in stores open more than one year. The stores posted real sales growth of 4.3 percent, after inflation in merchandise sales of 1.5 percent. Even with these higher sales, profits were below 1984's outstanding performance due to three factors. 7-Eleven pursued a more aggressive promotional strategy to increase market share in a competitive environment, which pressured gross margins on merchandise. In addition, an unprecedented increase in liability insurance premiums for businesses throughout the United States had a negative impact on the stores' results. Also, even though 7-Eleven is the most geographically diversified convenience retailer in the United States, its overall operating performance was affected by increased competition and the depressed economies in Houston and other Gulf Coast markets that depend on the energy industry.

7-Eleven self-serve gasoline sales and profits continued their strong upward trend in 1985, far outpacing the growth in national consumption. Volume was up 10.2 percent to 1.60 billion gallons, with average gross profit per gallon up 5.8 percent. In addition to the gasoline volume of 3,213 7-Eleven stores, another 380.3 million gallons were sold at 238 high-volume Super-7 and Quik Mart locations. Southland's 1985 retail sales of almost two billion gallons represent about two percent of total U.S. consumption, strengthening the Company's position as the nation's largest independent gasoline retailer.

One of Southland's key strategies is to continually improve the 7-Eleven store base. This is implemented not only by building most new stores on corner sites and remodeling existing stores on a regular basis, but also

by closing stores that no longer meet our performance criteria. As a result, the net unit increase in stores is lower in some years than others. Such was the case in 1985, when Southland opened 385 stores, relocated 67 to corner sites, closed another 166 due to changing market patterns and lease expirations, and sold 106 stores to other companies.

Chief Auto Parts acquired 101 properties in early 1985, increasing its store base by about 32 percent. The costs of assimilating and remerchandising those stores reduced Chief's profitability to the break-even point, even though its established stores reported good sales increases in a very competitive operating environment.

Southland's International Division continues to expand the Company's retail presence around the world. At year-end, 3,680 7-Eleven stores and other convenience retail units were operated by licensees or affiliates in the United States and 10 other countries. The licensee in Japan added 375 stores for a year-end total of 2,592, and the Hong Kong licensee opened its 100th store.

During the year, Southland sold R S McColl, which operates 377 candy, tobacco and news shops in the United Kingdom. The Company also signed a letter of intent to sell its 47 Gristede's grocery stores and Charles & Co. sandwich shops, which are located chiefly in the New York City area. These divestitures, like the sale of the 106 7-Eleven stores during the year, resulted from our strategic decision to discontinue some operations and withdraw from certain markets that are not an optimum fit with Southland's objectives.

The Dairies Group again outperformed its industry with significant sales and profit increases during 1985, while providing important support for 7-Eleven. The group continues to benefit from a decision made several years ago to modernize and expand its operations in fast-growing markets and increase the emphasis on high-margin products. In addition, the group's reputation for high-quality frozen novelties and juices has resulted in a number of important licensing agreements to produce name-brand products for other companies.

Southland's distribution system became a coast-to-coast operation when the fifth distribution center began deliveries in early June. Located in San Bernardino, California, the new center will serve 7-Eleven stores and other customers in the very important southern California, Arizona and Nevada markets.

Citgo's outstanding performance in 1985 resulted from improved refining and marketing conditions during most of the year and its advances in operating efficiency. The industry began to rebound in February when lower average crude costs and smaller refined product inventories helped stabilize product prices and restore reasonable profit margins. To reduce its exposure to negative industry conditions, Citgo lowered its working capital requirements and reduced operating expenses, which allowed it to benefit very quickly when margins improved.

However, since the beginning of 1986, there has been an unprecedented drop in refined product wholesale prices, which have fallen faster than dramatically declining crude costs due to excessive petroleum supplies on world markets. As a result, we have recognized in our reported 1985 fourth quarter results a decrease of $38 million, pretax, in the value of our year-end crude and wholesale refined product inventories, based on their sale in January and February 1986.

Citgo occupies a very favorable niche in today's refining and marketing environment, with the flexibility to produce high-value transportation fuels from a wide range of

Southland's distribution system became a coast-to-coast operation when the fifth distribution center, located in southern California, began deliveries in early June.

John P. Thompson

Jere W. Thompson

Citgo's outstanding performance in 1985 resulted from improved refining and marketing conditions and its advances in operating efficiency.

crude and intermediate feedstocks. In addition, new gasoline lead content regulations issued by the Environmental Protection Agency enable Citgo to achieve the maximum benefit from its ability to produce an all-unleaded slate of high-octane gasoline, with no additional capital investment.

To strengthen its market position, Citgo initiated a brand enhancement program for the 3,800 retail gasoline outlets served by Citgo distributors. The next phase of that effort, branding of gasoline sold by 2,400 7-Eleven stores east of the Rocky Mountains, began in late 1985. In conjunction with this program, a new "Citgo Plus" credit card was introduced that will be accepted at both the 7-Eleven stores and Citgo outlets for gasoline and merchandise purchases. We expect that the added convenience of the credit card, as well as consumer preference for name-brand gasoline and strong awareness of the Citgo name in the eastern United States, will enable both Citgo and 7-Eleven outlets to expand their customer base and increase the size of their average gasoline transaction.

7-Eleven is the leader in developing electronic customer services and expanding fast food operations to build both profit margins and customer traffic.

For almost 60 years, Southland has led the convenience store industry in responding to constantly changing customer needs, and is now concentrating on further development of several important competitive advantages. First, we continue to emphasize corner sites, with their higher visibility, accessibility and traffic counts. About 70 percent of existing stores and 90 percent of all new store sites are on corners. This strategy includes relocation of many mid-block stores to corners, which accounts for about one-fourth of the units closed each year.

Another important competitive advantage for 7-Eleven is its gasoline marketing strategy. Forty-three percent of existing stores sell gasoline, and that number continues to grow as 70 percent of all new stores have gasoline installations. In addition to providing an important source of income for our stores, gasoline sales also promote higher merchandise sales since over one-third of all gasoline customers purchase additional products or services.

7-Eleven has also established its leadership in aggressively introducing innovative electronic customer services such as automatic teller machines, which had been installed in more than 1,700 7-Eleven stores by the end of 1985. These services, which provide one of the best indications of how tomorrow's convenience store will serve its customers, are expected to expand our customer base, as well as add incremental sales and profits. After successful testing in several markets, videocassette and tape player rental programs will be introduced in more than 3,000 stores across the country in 1986. With our many neighborhood locations, operating hours and competitive pricing, 7-Eleven expects to become a major participant in the exciting videocassette rental business.

Our stores are also capitalizing on the potential of an expanded fast food operation to build both store merchandise margins and customer traffic. About 6,000 stores now offer freshly prepared fast foods such as hot dogs, nachos and deli-style sandwiches, while numerous other items are being tested to determine customer appeal.

While these new products and services increase store productivity, we also emphasize more effective training of store personnel, as well as increased use of labor-saving devices such as computerized inventory ordering systems and electronic cash registers.

Southland continues to follow a successful philosophy of maintaining conservative, yet flexible, financial policies that provide the strength and stability needed to pursue our many growth opportunities. Your Company is in a very strong financial position, as reflected by a debt-to-equity ratio at the end of 1985 that is at its lowest level in 10 years. Two

significant financial events occurred during the year — the first public offering of Southland equity since 1979 and Occidental Petroleum Corporation's offering of warrants to purchase the 9.5 million shares of Southland stock it received under the terms of our acquisition of Citgo in 1983. The proceeds of Southland's offering of $125 million of cumulative convertible exchangeable preferred stock were used to reduce long-term debt. The warrants, which are exercisable in July, will expand Southland's shareholder base in addition to increasing its market liquidity.

We continue to invest heavily in our basic business, convenience retailing, which accounted for more than two-thirds of capital expenditures in 1985. Total capital expenditures were about $476 million, with the majority of the funds provided by operations.

In the tenth year of fund raising for the Muscular Dystrophy Association, Southland employees, franchisees, customers and suppliers once again broke their own record, collecting $7.56 million for "Jerry's Kids" and the Labor Day Telethon. Over the last decade, they have collected more than $43 million to fight this crippling disease. In addition, more than $2 million was raised for the March of Dimes "WalkAmerica" in April, and Southland Dairies again served as a major corporate sponsor for the "Mothers March on Birth Defects."

Construction is under way on our new headquarters, with occupancy scheduled for late 1987. The 42-story office tower will satisfy the need to house our corporate and field support staff efficiently in one location. The new building will anchor Cityplace Center, the 24-acre nucleus of Southland's 130-acre mixed-use land development, located immediately north of Dallas' central business district and adjacent to a proposed major stop on the city's planned mass transit system. The balance of Cityplace Center will be built when sufficient tenant interest is indicated and satisfactory financing is arranged. The remaining acreage will be developed during the next 10 to 20 years as market conditions warrant.

In January 1986, the Board of Directors increased the dividend rate on common stock 12.0 percent to $1.12, the 11th consecutive annual increase and the largest increase in five years. This dividend, representing the Company's 30th year of uninterrupted dividend payments, will be a 25.5 percent payout of prior-year earnings, within the Board's 25-to-30-percent payout guideline. The first quarterly dividend at the new rate will be paid March 21, 1986, to shareholders of record on February 28.

We believe Southland will continue to excel due to its large, top-quality, geographically diverse retail base and efficient supporting businesses. The Company has funds available from both internal and external sources that allow it to take advantage of opportunities in the fast-growing convenience retail industry. We expect that, as the year progresses, improving conditions at Citgo, the anticipated successful completion of negotiations with Petroleos de Venezuela, S.A., and promising performances by 7-Eleven and our other traditional businesses should result in another good, but challenging, year for Southland. We appreciate the dedication of our employees, franchisees and suppliers, and we thank you, Southland's shareholders, for your confidence and support.

John P. Thompson

John P. Thompson
Chairman

Jere W. Thompson

Jere W. Thompson
President

March 17, 1986

Your Company is in a very strong financial position, as reflected by a debt-to-equity ratio at the end of 1985 that is the lowest in 10 years.

Southland will continue to excel due to its large, top-quality, geographically diverse retail base, efficient supporting businesses, and dedicated employees, franchisees and suppliers.

Convenience Retailing

Eight million customers a day shop at their neighborhood 7-Eleven stores; over half the U.S. population live within two miles of a 7-Eleven.

High-quality fast foods, such as freshly made deli-style sandwiches, hot dogs and nachos, are an important part of 7-Eleven's marketing strategy.

Electronic services attract new customers and increase the shopping frequency of current customers.

For the past decade, 7-Eleven has maintained a strong upward trend in gasoline sales, steadily increasing its market share during a time when total U.S. consumption remained relatively flat.

The convenience retailing segment reported record sales of $8.05 billion, which were up 4.5 percent over the prior year and represented 63.3 percent of Southland's total sales. Operating profits were $258.9 million, a decrease of 3.7 percent, and accounted for 66.7 percent of Southland's operating profits.

7-Eleven Sales Approach $7 Billion Mark

7-Eleven sales of $6.98 billion were up 8.8 percent, representing 86.7 percent of the convenience retailing segment. Merchandise sales increased 8.0 percent. In stores open more than 12 months, merchandise sales increased 5.9 percent, with real growth of 4.3 percent after inflation.

Operating profits were lower than last year's record results for several key reasons. Economic conditions remained depressed in Houston and along much of the Gulf Coast, negatively affecting 7-Eleven profitability in several markets that are heavily dependent on the oil and gas industry. Also, liability insurance premiums, which soared during the year for all businesses, added significantly to operating costs. In addition, aggressive promotions slightly lowered the gross margin on merchandise from the high level reached during 1984.

7-Eleven Gasoline Market Share Increases

Southland, the nation's largest independent gasoline retailer, sold 1.98 billion gallons in 1985 through 7-Eleven and its other self-serve outlets. Gasoline volume for 7-Eleven increased 10.2 percent to 1.60 billion gallons, and gross profit per gallon was up 5.8 percent, producing a 16.6 percent increase in total gross profit dollars. At year-end, gasoline was available at 3,213 7-Eleven stores, or almost 43 percent of all locations. For the past decade, 7-Eleven has maintained a strong upward trend in gasoline sales, steadily increasing market share while total U.S. consumption remained relatively flat.

In addition to 7-Eleven, Southland operates 28 Super-7 and 210 Quik Mart high-volume gasoline stores, which sold 380.3 million gallons in 1985. These stores also offer customers a limited assortment of convenience merchandise.

Citgo Branding, Credit Card to Attract Customers

In late 1985, Southland announced it would introduce the Citgo brand at 7-Eleven gasoline locations, realizing another benefit from the relationship between Southland and Citgo and increasing the gasoline sales potential of 7-Eleven. The first phase of this branding program in 2,400 stores east of the Rocky Mountains was completed by February 1986. Aggressive promotional activities will support the program, including point-of-sale advertising, pump decals and the addition of the Citgo name, which is well-known in the eastern United States. Customers can also buy gasoline and merchandise with the new "Citgo Plus" credit card, which will be offered to millions of potential cardholders

While 7-Eleven continually develops new products to meet changing customer needs, long-time favorites such as "Slurpee" semi-frozen carbonated drinks offer timeless appeal.

Segment Operating Results *(Millions)*

	1981	1982	1983	1984	1985	Five-Year Compound Growth
Sales	$5,187.2	$5,816.3	$6,820.7	$7,707.3	**$8,054.8**	**13.2%**
Operating Profit	212.6	222.5	238.2	268.8	**258.9**	**8.4%**

over the next two years. Customer preference for name-brand gasoline and the convenience of the credit card are key elements in 7-Eleven's strategy to strengthen customer loyalty and increase the average transaction size.

7-Eleven Emphasizes Corner Sites, Remodels Almost 1,000 Stores

At year-end, 7,519 7-Eleven stores were operating in 41 states, the District of Columbia and five provinces of Canada, with more than 70 percent located on highly visible corner sites. Franchisees operate 38 percent of Southland's 7-Eleven units.

Courteous, efficient customer service is an important part of 7-Eleven's convenience concept. Store manager candidates receive extensive on-the-job training and classroom instruction to prepare for their increased responsibilities.

The Company opened 385 stores during the year and closed 339. The closed units included 67 that were relocated to corner sites, another 166 that were closed due to changing market patterns and lease expirations, and 106 stores that were sold to other companies. These divestitures, which were part of Southland's planned withdrawal from certain markets, will enable it to concentrate on markets with solid growth potential.

Southland also remodeled almost 1,000 stores in 1985, following its strategy to continually upgrade the 7-Eleven store base. Many of these units feature new exteriors and interiors, which were redesigned to highlight 7-Eleven's fast food program and increase store productivity. The new exterior, featured on the front cover of this report, is the prototype for new and remodeled stores across the country.

7-Eleven Sales by Category

Gasoline	25.5%
Tobacco Products	14.8
Beer/Wine	11.0
Soft Drinks	10.6
Groceries	10.1
Non-Foods	7.1
Other Food Items	5.6
Dairy Products	5.3
Candy	3.9
Baked Goods	3.4
Health/Beauty Aids	2.7
Total	100.0%

The Company does not record sales by product lines, but estimates the percentage of 7-Eleven sales by principal product category based upon total store purchases.

Marketing Strategy Focuses on Fresh Fast Foods and Electronic Services

7-Eleven's marketing strategy emphasizes high-quality fast food products and electronic services to attract new customers and increase the shopping frequency of current customers. Using extensive research, Southland anticipates market trends so that its eight million customers per day can find "what they want, where and when they want it," at their neighborhood 7-Eleven store.

In response to growing customer preference for fresh fast foods, deli-style sandwiches are now made on-premises at 2,500 stores, while hot dogs and nachos are available at 6,000 locations. As a result, 7-Eleven customers have a wider choice of foods for a quick meal than is available at most fast food restaurants. Additional hot entrees, such as pizza and beef-with-gravy sandwiches, are also being tested.

7-Eleven continues to lead the convenience store industry in offering financial and other electronic services to its customers. Automatic teller machines (ATMs), which were installed in more than 1,700 stores by the end of 1985, attract customers because they accept a wide variety of cards and are accessible 24 hours a day. Southland's experience with these machines indicates important marketing potential for a wide range of other services. They encourage more frequent customer trips to 7-Eleven and associated purchases of merchandise and gasoline.

Southland Continues to Expand Services

Videocassette rentals were successfully tested in several 7-Eleven markets in 1985, and a nationwide expansion of the program began in early 1986. Vendor agreements have been signed to install rental centers in more than 3,000 stores by year-end, with additional locations to be added in 1987. 7-Eleven will offer customers a very competitive combination of value and convenience, with fast checkout, a well-stocked supply of the most popular titles rotated on a regular basis, videocassette players for rent, the lowest rental fees in town and easily accessible locations that are open around the clock.

7-Eleven is also testing automation of money order sales to increase customer convenience by reducing transaction time and simplifying administration. 7-Eleven has offered this product to customers for 29 years and is second only to the United States Postal Service in money order sales. Other electronic and financial services being tested include debit cards for gasoline sales and the direct ordering of a wide variety of merchandise through in-store computer terminals. In addition, 7-Eleven now accepts MasterCard and Visa cards across the nation and also sells lottery tickets in 19 states and the District of Columbia.

7-Eleven's videocassette rental operation has been scheduled for installation in more than 3,000 stores in 1986 following successful testing in several markets during 1985. Customers will find a well-stocked supply of the most popular movie titles, competitive prices and around-the-clock, convenient accessibility.

7-Eleven means "convenience" in 10 countries in addition to the United States and Canada. The Hong Kong licensee celebrated its 100th 7-Eleven store with a grand opening that attracted thousands of customers.

Southland International Extends 7-Eleven Presence Around the World

The International Division coordinates the activities of 3,680 7-Eleven stores, operated primarily by licensees, in the United States and 10 other countries. Almost 80 percent of these stores are located in the Far East and South Pacific, where license agreements are in effect for seven countries. Seven-Eleven Japan Co., Ltd., the largest area licensee, ended the year with 2,592 stores, including 375 opened in 1985. For other Pacific Basin countries, the number of stores opened during 1985 and total number of units at year-end were: Hong Kong, 41 and 136; Australia, 27 and 96; Taiwan, 24 and 88; Singapore, 4 and 22; Malaysia, 10 and 13; and the Philippines, 1 and 3.

In the United Kingdom, Guinness PLC, a large British consumer products and services group, acquired the 7-Eleven license from the previous licensee and at year-end was operating 45 7-Eleven stores in England, an addition of 30 for the year. In an unrelated transaction, Guinness purchased Southland's subsidiary, R S McColl, which operates 377 confectionery, tobacco and news shops in the United Kingdom.

The Company's Swedish subsidiary operated 65 7-Eleven stores at year-end, 16 more than the prior year. Southland also owns an equity interest in a company that operates 46 Super Siete convenience stores in Mexico.

Ten American licensees, who operate 7-Eleven stores in designated areas of 24 states, including Alaska, had 574 stores open at the end of the year. A new license was granted for selected areas of Pennsylvania, and three stores were opened by year-end. Garb-Ko, which in 1969 received Southland's first 7-Eleven area license, added 14 stores in northern Michigan for a total of 114 at the end of the year.

Southland's highly automated distribution system serves almost 5,500 7-Eleven stores, as well as outside customers. The system helps maximize 7-Eleven's sales and profits by increasing the number of items that can be stocked, improving inventory turnover and maintaining fresher merchandise.

Sales from these stores are not reported as revenues of Southland. Royalties from licensees are included in the convenience retailing segment's operating profit.

Opening of California Distribution Center Expands System Coverage Across the Nation

Southland's five distribution centers supply retail and food service customers in 37 states and the District of Columbia, including 73 percent of the 7-Eleven stores. The centers, which are strategically located in Florida, Texas, Virginia, Illinois and California, enable 7-Eleven and other customers to improve inventory turnover, maintain fresher merchandise, and produce higher sales and profits in their limited selling space. Total 1985 sales reached $1.23 billion, up 9.4 percent. Outside sales accounted for $272.5 million.

All four of the established centers improved in profitability during 1985. However, start-up costs of the San Bernardino, California, center, which made its initial deliveries in June, reduced the group's profits for the year. The new center is developing its customer base among franchised 7-Eleven stores in southern California and parts of Arizona and Nevada and currently serves 85 percent of those stores. It incorporates design and technological developments that provide almost as much capacity as any of the other centers, but in less square footage.

The other distribution centers expanded the application of several productivity measures during the year, including a system that uses relay drivers to reduce the labor costs on long distribution routes by as much as 50 percent.

Chief Auto Parts Strengthens Market Position

Chief Auto Parts acquired 101 properties in early 1985, further strengthening its position as the nation's largest convenience retailer of automobile replacement parts and accessories operating under one name. During the year, Chief opened or acquired a total of 159 stores and closed 52, for a 32-percent net increase. At year-end, 444 Chief stores were operating in California and Texas, as well as seven other states.

Chief Auto Parts, the largest retailer of automobile replacement parts operating under one name, introduced an industry first in 1985—a five-year/50,000-mile warranty. Do-it-yourself mechanics appreciate Chief's extended operating hours, as well as the convenient self-serve format of its stores.

Sales were up in Chief stores operating prior to the acquisition, despite continued intense competition. Customers responded favorably to Chief's introduction in early 1985 of a five-year/50,000-mile warranty for certain replacement parts, and product mix was improved by the addition of more foreign car parts and a greater emphasis on high-margin replacement parts. Chief reported break-even results for the year, following a profitable 1984, due to expenses associated with the remerchandising and assimilation of the newly acquired stores.

Food Processing and Manufacturing

The segment reported record operating results for 1985, led by an outstanding performance by the Dairies Group.

Seven food processing and manufacturing businesses provide important support to 7-Eleven stores and also serve a growing number of outside customers.

The Dairies Group produces and distributes a complete line of items including popular frozen novelties and juices.

The Dairies Group, six food centers and five other businesses in the food processing and manufacturing segment produce and market products to other Southland operations and outside customers. Segment sales increased 10.8 percent to $803.3 million in 1985. Outside sales, which accounted for 64.4 percent of the total, increased 16.7 percent to $517.5 million. An outstanding performance by the Dairies Group contributed substantially to the segment's record results of $32.3 million in operating profits. The food centers and Tidel Systems also reported excellent earnings increases.

High-Margin Products, Direct Store-Door Delivery Expertise Boost Dairies' Profits

The Dairies Group operates under nine brand names and serves customers in all 50 states, the District of Columbia, Canada, Japan and the Caribbean. It is one of the largest dairy processors and distributors in the nation, with 23 processing plants and 68 distribution points. In addition to more than 5,500 7-Eleven stores, its customers include thousands of other retail, institutional and food service accounts that have been attracted by the dairies' expertise in direct store-door deliveries. The Dairies Group also produces and distributes nationally known milk and juice products under licensing agreements with a number of other companies. Group sales in 1985 increased 10.3 percent, with sales to outside customers representing 58.3 percent of the total.

Operating profits were up significantly in 1985, the third consecutive year of record results. The Dairies Group has consistently outperformed its industry by emphasizing high-margin items such as ice cream, frozen confections, cultured and ultrapasteurized products, and juices. Many of these products are marketed nationally under Southland's brand names, such as "Naturally Yours" yogurt, "Barricini" ice cream and "Trimline" cottage cheese. In addition, continued emphasis on plant productivity has enabled the Dairies Group to realize higher profits from its fluid milk operations, which processed almost 200 million gallons of milk in 1985.

Licenses Added for New Frozen Novelties

In addition to its own novelties, such as the "Big Wheel," "Big Deal" and "Bomb Pop," Southland also manufactures and distributes several unique branded products under licenses from other companies. The Dairies Group has exclusive agreements for the production of the phenomenally successful Dole "Fruit 'N Juice" bar, as well as Dole "Fruit Sorbet," and for the Dole "Fruit 'N Cream" bar, which was introduced in 1985. Other products include A&W's "Root Beer Float-on-a-Stick," Welch's "Grape Juice Bar" and the Oreo "Cookies 'N Cream Sandwich."

Dairy Brand Names

Adohr Farms	Oak Farms
Bancroft	Specialty Products
Cabell's	Velda Farms
Embassy	Wanzer's
Merritt Foods	

The dairies' reputation for quality frozen novelties and other specialty items has resulted in licensing agreements to manufacture and distribute many popular name-brand products.

Segment Operating Results *(Millions)*

	1981	1982	1983	1984	1985	Five-Year Compound Growth
Outside Sales	$420.8	$397.0	$395.8	$443.6	**$517.5**	4.1%
Intersegment Sales	206.3	234.9	263.8	281.4	**285.8**	9.6%
Total Sales	627.1	631.9	659.6	725.0	**803.3**	5.9%
Operating Profit	16.7	17.8	24.7	29.2	**32.3**	12.9%

A significant expansion of the licensed products program occurred in 1985 when the Dairies Group signed a five-year exclusive licensing agreement to develop, manufacture and distribute frozen novelties based on the well-known "Peanuts" cartoon characters. Merritt Foods, Southland's frozen novelty division in Kansas City, Missouri, will introduce the first of its "Peanuts"-theme novelties, the "Red Baron Bomb Pop" and the "Joe Cool Bomb Pop," in 1986. With frozen novelty sales growing rapidly, the Dairies Group acquired an additional plant, in Atlanta, Georgia.

The Food Labs Division's natural flavorings are important ingredients in a variety of products, including yogurt and carbonated fruit drinks.

Growth of "Farmfield" and "Mission San Juan" Juices Leads to Plant Acquisition

The dairies also process and distribute "Farmfield" juice drinks and "Mission San Juan" all-natural premium fruit juices. In addition, they produce "Minute Maid" orange juice, "Hi-C" fruit drinks and additional juice products for other companies. Because of the growth in Southland's juice sales over the last several years, the Company acquired a plant in central California, which increases to 10 the number of dairy plants that process juices.

Food Centers Increase Outside Sales 16 Percent

Southland's six food centers produce a wide assortment of sandwiches and other items, such as French bread pizza, burritos, snack cakes, and syrups for "Slurpee" and other beverages. Located at four of the distribution centers and in Salt Lake City, Utah, and St. Louis, Missouri, the centers support the 7-Eleven fast food program, as well as cater to an increasing number of vending, institutional and other convenience store accounts. In 1985, outside sales were up 16 percent over the prior year.

The Utah center produced 3.5 million pounds of chili sauce during the year, most of which was supplied to 7-Eleven stores for their highly successful fresh-made chili dogs. The facility also introduced a chicken burrito, as well as a line of eight-ounce burritos, to complement its five-ounce products. The Illinois center began producing cheese sauce, previously available only from the Utah facility, to support 7-Eleven's popular nacho program. The plant also added three new varieties to its French bread pizza line, which helped produce a 47-percent increase in unit sales. In addition, the Missouri center introduced the "Crackle Bar," a marshmallow-based snack cake.

El-Ge and Pate Offer Snack Food Opportunities

The Pate Foods and El-Ge Potato Chip divisions, acquired in 1983 and 1984, respectively, have expanded Southland's snack food program into corn- and potato-based products. Pate, which distributes corn chips, popcorn and other corn-based products in 12 North Central states, began producing a corn chip line for El-Ge in early 1986. El-Ge, a 7-Eleven supplier in the Northeast for 25 years, introduced two new products in 1985, an extra-thick potato chip and a premium homecooked-style potato chip.

Food Labs Division Increases Sales of Aseptic Fruits and Flavors

The Food Labs Division manufactures a broad line of food ingredients and specialty chemicals for Southland operations and a growing number of other customers. Outside sales account for 74 percent of the total. The division's Dallas, Texas, facility, which increased sales of aseptically processed fruits

and flavors by 64 percent, is one of only two processors of fruit juice used in the new carbonated "Slice" drink. Aseptic flavors, which are produced by an oxygen-free cooking method, have greater taste, color and shelf stability than those processed by other methods. Other aseptic products are fruits for both fresh and frozen yogurt, including Southland's own "Naturally Yours" brand. The division also supplies "Slurpee" flavor concentrates to the food centers, where they are used to make syrup for 7-Eleven's popular semi-frozen carbonated soft drink.

Reddy Ice Begins New Florida Plant

Reddy Ice, Southland's original business, is the largest manufacturer of fragmentary ice in the world. With outside customers accounting for 65 percent of total sales, the division operates eight plants, located in Texas, Oklahoma, Nevada and Florida. Construction began in early 1986 on a state-of-the-art plant in Fort Lauderdale, which will serve customers in southern Florida markets.

Tidel's "Cash Controller" Achieves Strong Sales

Tidel Systems posted gains in sales and profits for the fifth consecutive year due to the continued success of its "Timed Access Cash Controller," a cash dispenser and drop safe. Almost 5,500 units were sold in 1985, bringing the total number placed in operation since 1978 to more than 40,000. Originally designed for 7-Eleven stores, the machine is widely recognized by retailers as an effective crime-deterrent.

Tidel also installed almost 300 "Gas Tank Monitors" in 7-Eleven stores during the year. These machines use sonar and microprocessor technology to provide centralized inventory control and leak detection for multiple gasoline storage tanks. In 1985, the division increased the capacity of its metal fabricating equipment, which it uses to manufacture stainless steel fast food counters and other items for 7-Eleven stores, as well as products such as pay telephone casings for other customers.

(Left) *The Salt Lake City food center, one of six operated by Southland, produced 3.5 million pounds of chili sauce and 24 million burritos in 1985.* (Right) *Tidel, which makes the "Timed Access Cash Controller" for 7-Eleven and other customers, also began to manufacture pay telephone casings during the year.*

Gasoline Refining and Supply

Citgo's outstanding performance in 1985 began during the first quarter when it very quickly regained profitability after refining and marketing industry conditions sharply improved.

The Lake Charles, Louisiana, refinery can produce a large volume of high-octane unleaded gasoline with no additional investment in facilities.

Citgo's marketing and distribution operation supplied 5.88 billion gallons of fuel and additional products to 7-Eleven and other customers during 1985.

The gasoline refining and supply segment consists of the refining, marketing and transportation operations of Citgo Petroleum Corporation. Total segment sales in 1985 were $5.69 billion, of which $4.14 billion or 73 percent was to outside customers. Operating profits increased to $96.8 million, representing 25.0 percent of Southland's total operating profits for the year. These results include recognition of a decrease of $38 million, pretax, in the value of year-end crude and wholesale refined product inventories, based on their sale in January and February 1986. This retroactive write-down of inventories to the lower of cost or market value resulted from an unprecedented drop in refined product wholesale prices that have fallen faster than dramatically declining crude costs due to excessive petroleum supplies on world markets.

On February 5, 1986, Southland announced that it had signed a letter of intent outlining the framework for negotiations to sell a 50-percent equity interest in Citgo to a subsidiary of Petroleos de Venezuela, S.A. (PDVSA), Venezuela's state-owned oil company. When completed, the new arrangement will help ensure a long-term supply of crude oil for the refinery at prices that reflect market conditions in the United States and should also reduce Citgo's exposure to the historically cyclical nature of the refining industry.

Citgo Profits Rebound Sharply

Citgo's outstanding performance in 1985 began during the first quarter when it very quickly regained profitability after refining and marketing industry conditions sharply improved. Excess industry capacity, combined with the effect on product prices of the market's anticipation of less expensive crude oil, had severely pressured operating margins in late 1984 and early 1985. Because of this pressure, Citgo reduced its refinery operating rate by 46 percent to 140,000 barrels per day, thereby decreasing its exposure to unfavorable industry conditions. Citgo increased its purchases of refined products on the spot market to ensure that supplies to customers were not interrupted. At the same time, Citgo significantly reduced its working capital needs by cutting inventories to minimum operating levels and lowered its average crude cost by aggressively reducing its posted prices paid for domestic crudes.

Margins began to improve dramatically in February 1985 as refined product prices increased and crude oil costs eased. In addition, the price of heavy crude dropped rapidly when the lengthy British coal strike ended, restoring its historical price advantage over lighter grades of crude. Meanwhile, the refining industry more effectively managed product inventories during 1985 by operating at rates balanced to realistic demand, which further strengthened refined product prices.

As margins improved, the refinery's crude runs were gradually increased to about 225,000 barrels per day. This included larger quantities of the cheaper heavy crudes, which significantly reduced Citgo's average crude cost. Citgo took several other steps to improve its position as an efficient, low-cost, high-quality refiner/marketer, including the

The Citgo brand name has been added to more than 2,400 7-Eleven stores selling gasoline, further increasing Citgo's name awareness and satisfying customer preference for branded gasoline.

Segment Operating Results *(Millions)*

	1981	1982	1983	1984	1985
Outside Sales	$ 84.8	$ 542.6	$1,554.7	$3,882.0	**$4,140.9**
Intersegment Sales	18.5	713.2	1,198.7	1,520.5	**1,549.9**
Total Sales	103.3	1,255.8	2,753.4	5,402.5	**5,690.8**
Operating Profit*	3.0	22.9	22.7	15.5	**96.8**

**Does not include interest expense or equity in earnings of pipeline companies*

The refinery's 45,000-barrel-per-day catalytic reformer provides high-octane unleaded gasoline capability, a significant marketing advantage because of new lead content regulations for gasoline.

The Lake Charles refinery's state-of-the-art computerized process control system continuously monitors and adjusts refinery operations to maximize energy savings and increase overall unit efficiency.

reorganization of its operations along three primary business lines — light fuels (gasoline, distillates and turbine fuel), lubricants and specialty products, and industrial products such as petroleum coke. This restructuring is expected to improve management focus and maximize the profit potential of each business line's unique distribution and marketing characteristics. The business unit structure also provides greater autonomy, flexibility and management accountability for day-to-day decision-making and implementation of business strategies.

Refinery Flexibility, Unleaded Gasoline Capacity Improve Competitive Position

Among Citgo's more important assets is the Lake Charles, Louisiana, refinery, which underwent extensive capital improvements that began in 1980 and were nearly complete by the time Southland acquired the company in 1983. These projects, including a hydrocracker, coker and high-octane catalytic reforming unit, significantly increased the refinery's "conversion" capability — its capacity to convert lower-value residual fuel oil into higher-value transportation fuels such as gasoline, diesel and aviation fuel. Citgo's conversion equipment improves its operating margins by reducing crude and other feedstock costs, while at the same time capturing a higher value for the products it manufactures.

As an example of this efficient conversion equipment, the hydrocracker facilitates production shifts between gasoline and distillates and increases the yield of high-value products from each barrel of crude, thereby increasing profitability. The coker enables Citgo to refine large quantities of less expensive heavy sour (high-sulfur) crude oil, which

reduces average crude costs. In addition, the refinery's high-octane capability for gasoline increased significantly with the completion of the 45,000-barrel-per-day catalytic reformer in 1982. Citgo is therefore equipped to immediately begin cost-competitive production of gasoline that is both unleaded and high-octane, enabling the company to meet the Environmental Protection Agency's new gasoline lead phasedown requirements with no additional investment. High-octane capability also allows Citgo to benefit from growing demand for premium unleaded gasoline among owners of today's high-performance automobiles.

These new facilities made Citgo's hardware configuration highly profitable in 1985 as crude oil and refined product markets rewarded those refiners with the ability to process large quantities of less expensive heavy sour crude oil into high-octane gasoline and turbine fuel. As worldwide demand for residual or heavy fuel oil continues to decline, Citgo's conversion facilities are expected to provide an even greater contribution to profitability.

During much of 1985, nearly 40 percent of the refinery's 225,000-barrel-per-day crude throughput was heavy sour crude, significantly increasing Citgo's profitability. At the same time, the conversion equipment operated virtually at full capacity, further boosting earnings.

Four Billion Gallons of Gasoline Supplied to 7-Eleven, Other Wholesale Customers

Citgo's light fuels marketing and distribution operation supplies almost all of the two-billion-gallon annual retail gasoline requirement of 7-Eleven and Southland's other outlets. More than two billion additional gallons are supplied to outside gasoline customers, including over 300 independent wholesale distributors who serve more than 3,800 Citgo-branded retail units. Citgo's wholesale gasoline sales volume to these distributors in 1985 increased 14 percent over the previous year. In addition to gasoline, Citgo supplies about 1.8 billion gallons of diesel, fuel oil and other products to customers across the country. These include a six percent share of the nation's aviation turbine fuel, which is sold to national and commuter airlines at 21 airports.

Although the Lake Charles refinery supplies the majority of the 5.88-billion-gallon total requirement of Citgo's customers, including Southland, Citgo also supplements its refinery production with substantial spot market purchases of refined products. To facilitate quick, cost-effective delivery to customers across the country, Citgo has 41 refined product terminals, five of which are jointly owned, which provide total storage capacity of 17 million barrels. Exchange agreements with 275 other terminals in key locations further strengthen Citgo's widespread distribution capability.

Citgo supplied 1.66 billion gallons of gasoline in 1985 to distributors serving its 3,800 independent branded outlets. Sales volume to these distributors increased 14 percent over the prior year, due in part to a brand-enhancement program.

Citgo's new credit card, which will be offered to millions of customers over the next two years, is accepted for gasoline and merchandise purchases at more than 6,000 Citgo-branded outlets and 7-Eleven stores.

Citgo Brand Enhanced with Introduction of New Branding Package, "Citgo Plus" Card

In 1985, Citgo initiated a major brand enhancement program aimed at broadening the customer awareness of its name — already well-known in many markets in the eastern United States. In the initial phase of the program, an aggressive and competitive "brand package" was developed to assist Citgo's distributors in increasing the value of the Citgo trademark. In the second phase, 7-Eleven stores east of the Rocky Mountains that sell gasoline are adding the Citgo brand, doubling the availability of Citgo-branded products. A new "Citgo Plus" credit card has also been introduced, which will be accepted at more than 6,000 branded distributor locations and 7-Eleven stores.

The combination of Citgo-branded products at 7-Eleven locations and expanded credit card availability should considerably enhance Citgo's name identification. By February 1986, over 2,400 7-Eleven gasoline stores were displaying Citgo identification and honoring the credit card. The final branding phase of those stores, including permanent signage and installation of time-saving electronic credit card authorization equipment, is expected to be virtually complete by the end of the year.

Of special interest to "Citgo Plus" cardholders is the convenience of a new revolving credit line, which enables them to finance a limited amount of gasoline and merchandise purchases at both 7-Eleven stores and Citgo-branded distributor outlets, as well as repair services, tires, batteries and automotive accessories at the distributor outlets. Over the next two years, the card will be offered to millions of potential new customers, providing an important opportunity to increase Citgo's active cardholder base. The widespread availability of Citgo products, along with the added convenience of the new credit card, is expected to increase sales opportunities significantly for both types of retail units.

Six percent of the nation's aviation turbine fuel is supplied by Citgo through sales to national and commuter airlines at 21 airports.

Citgo Is Major Supplier of Lubricants, Industrial Products

Citgo has been a leading supplier of lubricants, waxes and related specialty products for 50 years. The markets for lubricants and waxes are closely tied to general economic activity, making this business line less volatile than gasoline and other fuels. Citgo increased lubricants sales during 1985, despite volume decreases for the industry as a whole. Motor oil sales were especially strong due to improved distributor sales and a sizeable increase in demand for two- and five-quart plastic containers. Citgo launched the popular plastic packages for motor oil in 1978 when it introduced the first plastic funnel-top container. Today, it is the only supplier of motor oil in "elephant-trunk" containers, including the newly introduced two-quart size.

The Citgo lubricants business includes a 65-percent interest in the Cit-Con lubricants refinery at Lake Charles, the seventh largest in

As illustrated by the data on the facing page, Southland has sustained a record of solid growth in sales, earnings and dividend payments while maintaining and enhancing its basic financial strength. The strength of the Company's operating performance has provided the basis for funding Southland's aggressive growth program.

Compounded annually, total revenues during the last five years have increased 21.7 percent, while primary earnings per share have grown 15.3 percent despite the issue of new shares for the Citgo acquisition in 1983. Since 1980, dividends per common share have compounded at a rate of 10.0 percent per year, and shareholders' equity per common share has grown 13.4 percent per year.

Southland's primary financial objective is to maintain a balance between sustaining above-average operating performance and preserving the financial foundation required to support the Company's continuing expansion. The Company has consistently achieved this objective, with 24 consecutive years of higher revenues and earnings and an unbroken record of dividend payments reaching back to 1957.

A discussion of Southland's overall financial position in 1985 follows:

Balance Sheet

During 1985, a Company objective was to improve balance sheet ratios, with particular emphasis on interest coverage and debt-to-equity ratios and return on shareholders' equity. To achieve this goal, the Company's long-term debt level was reduced with proceeds from a $125 million preferred stock issue, cash from the sale of certain assets no longer needed in the business and funds generated from continuing operations. Issuance of the preferred stock has improved Southland's debt-to-equity ratio and increased its financing flexibility.

The interest coverage ratio improved in 1985 due to reduced debt levels, higher earnings and the sale of accounts receivable, the costs of which are included in selling, general and administrative expenses.

Increased earnings for the year resulted in an improvement in the return on average shareholders' equity, even after taking into account the dilutive effect of the preferred stock issue.

Asset Management

Achieving maximum long-term return on assets is another important Southland objective. Consequently, management monitors and assesses the performance of all business units and redeploys assets that no longer meet strategic goals. Consistent with this objective, in 1985 the Company sold 106 7-Eleven stores, as well as its affiliate in the United Kingdom, Southland-McColl Limited, which operated in Scotland and northern England. In February 1986, the Company announced that it had agreed to sell Gristede's, its 47-store grocery chain.

To better ensure its crude oil supplies and reduce the impact on Southland of the volatility of Citgo's earnings, the Company in February 1986 signed a letter of intent to negotiate the sale of a 50-percent interest in its wholly owned Citgo Petroleum Corporation to a subsidiary of Venezuela's state-owned Petroleos de Venezuela, S.A. (PDVSA). Under terms of the proposal, which is expected to be finalized by mid-1986, PDVSA will pay approximately $290 million in cash and notes for its interest in Citgo and provide its share of Citgo's working capital requirements.

Cash proceeds from these two proposed 1986 transactions will be used by Southland to reduce debt and to finance the Company's capital programs with emphasis on its core businesses.

Sources of Funds

Historically, as in 1985, the high level of cash flow from Southland's continuing operations has made substantial funds available for use in the Company's capital investment activities. Net earnings in 1985 of $212.5 million, together with expenses not requiring the use of cash (depreciation, amortization and deferred tax provision), generated $404.6 million, an increase of 10.1 percent or $37.0 million from 1984. These internally generated funds represented 85.0 percent of the total capital expenditures for the year. Funding requirements in excess of operating cash flow were provided by outside financing sources and the sale of assets no longer used in the business.

Uses of Funds

The reduction and retirement of long-term debt, which includes capitalized leases, was $233.9 million in 1985. Overall, long-term debt was reduced by 20 percent from the 1984 year-end level.

Capital expenditures of $476.1 million accounted for the single largest use of funds by the Company in 1985, reflecting Southland's commitment to capital investment programs designed to expand operations and improve productivity. Of the 1985 total, 68.8 percent was expended for property, plant and equipment for the convenience retailing segment. These funds were used primarily for the construction of 385 new 7-Eleven stores, the acquisition and development of new store sites, and the remodeling and modernization of existing units. Exacting store site selection criteria, including demographic and financial rate of return requirements, continue to increase the quality and profit potential of new stores.

Other major capital expenditures during 1985 were for the completion of a new distribution center in San Bernardino, California, the construction and acquisition of 159 Chief Auto Parts stores, and the initial construction costs associated with the Company's new corporate office.

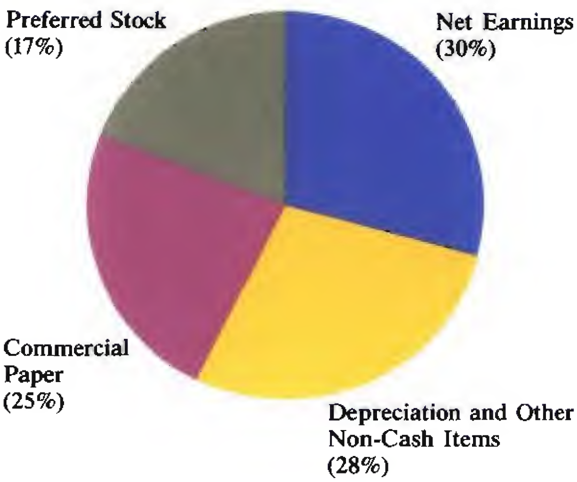
The Company anticipates that 1986 capital expenditures for 7-Eleven and its other traditional businesses will be maintained at or above their current levels. Because of the large number of these small individual projects with construction dates staggered throughout the year, the Company retains considerable flexibility to respond quickly to changing capital market conditions with appropriate changes in related capital spending schedules. Required capital expenditures for maintenance and modernization of existing facilities, as well as a reduced level of expansion, can be funded entirely from internally generated cash if capital market conditions should make it necessary to do so.

Construction of the new headquarters will continue during 1986, while the second phase of Cityplace Center, a multi-use commercial development adjacent to the headquarters, will proceed as market conditions permit.

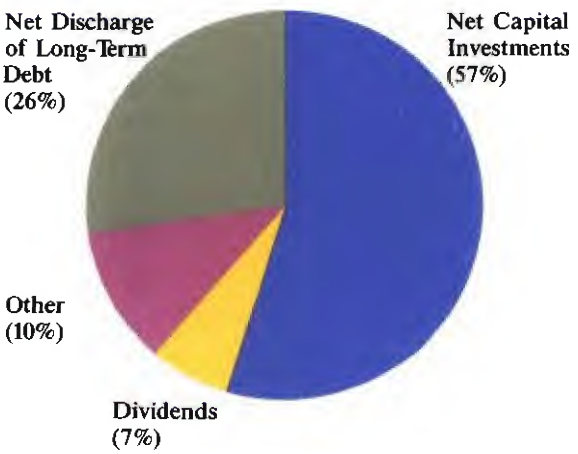
Dividends on common stock paid to shareholders in 1985 totaled $47.4 million, or $1.00 per share. In January 1986, the Board of Directors increased the annual dividend rate by 12.0 percent to $1.12 per share, which will be effective with the quarterly payment in March 1986.

Dividends paid on the Company's Series A Cumulative Convertible Exchangeable Preferred Stock during 1985 were $2.2 million, or $.86 per share, equivalent to an annual rate of $4.00 per share.

Sources of Funds — 1985



Uses of Funds — 1985



Financing Activities

As a growth-oriented company, Southland seeks to maximize financial flexibility so it can use the most advantageous and timely financing vehicles available.

One of these alternatives, commercial paper, is an important source of funding for the Company that provides a flexible approach to cash planning and financing. Its use is especially advantageous because of the seasonal nature of Southland's businesses. In addition to its flexibility, commercial paper has been available to the Company at a lower cost than long-term debt. Quick access to commercial paper markets and sophisticated internal forecasting and cash management systems have enabled Southland to maintain cash balances at low levels, thereby minimizing borrowing and interest costs. At year-end, when seasonal cash requirements are near their peak, \$425 million of commercial paper was outstanding. The average balance during the year was about \$215 million. Since Southland's commercial paper is backed by a long-term credit facility and the Company anticipates that at least \$150 million will be outstanding throughout the year, that amount is classified as long-term debt. All or part of the Company's commercial paper can be converted into long-term debt whenever fiscally prudent and advantageous.

During July 1985, the Company's Canadian subsidiary issued 12 percent notes due 1992 in the principal amount of \$50 million Canadian (approximately \$37 million in U.S. dollars). These notes, issued through a consortium of European banks, increased Southland's visibility in international financial markets, enhancing future accessibility to these sources for larger financial transactions.

In August 1985, the Company issued \$125 million of Series A Cumulative Convertible Exchangeable Preferred Stock. The exchange feature of this issue provides additional flexibility in that the Company may, after 1988, exchange the issue for convertible subordinated debt if its capital structure at that time makes additional leverage desirable.

While evaluating several alternatives available to finance construction of its new corporate headquarters facility, the Company is currently utilizing commercial paper on an interim basis to finance the initial phase of this project. Southland's objective is to replace this temporary financing, as well as that for other phases of the project, with permanent nonrecourse financing.

Capital and operating leases continue to be important elements in the financing alternatives available to the Company as it carries out planned expansions.

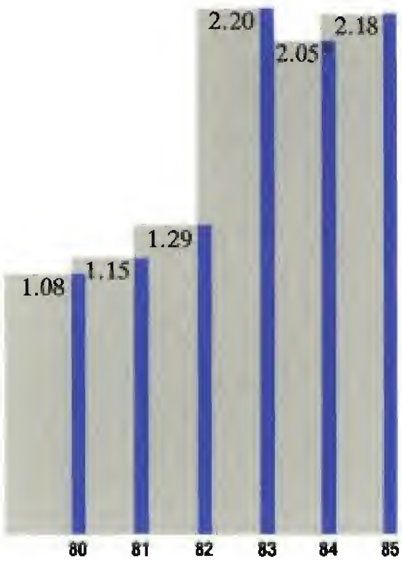
Other Sources of Credit

In order to meet remaining anticipated funding requirements, the Company maintains a number of additional credit facilities.

In December 1984, the Company entered into a five-year agreement under which it can sell up to $275 million of accounts receivable. The commitment can be extended annually on a rollover basis and provides funding at favorable rates. The purchaser has agreed to invest collected amounts in new purchases, providing a stable level of purchased accounts. Since most of the accounts receivable sold relate to Citgo, the pending sale of 50 percent of Citgo may require revisions to this agreement.

During 1985, Citgo maintained a $375 million revolving term credit facility while Southland maintained a $200 million revolving line of credit with a group of banks. In March 1986, the Company consolidated these facilities into a single $400 million revolving line of credit with 17 American and Canadian banks, providing significant cost savings. In addition, Citgo's inventories are no longer pledged as collateral.

Total Capitalization
(Dollars in Billions)



**Capitalization decrease primarily due to sale of accounts receivable*

The Company also maintains a $200 million revolving line of credit with a consortium of nine major European, Canadian and Japanese banks. There were no borrowings under this line during the year. In addition, the Company has arranged for $210 million in uncommitted bank lines that can be used on short notice and for $30 million in master notes that are placed through bank trust departments at very attractive rates. At year-end, the Company had drawn $39 million under these arrangements, leaving $201 million available.

Credit Ratings

Southland's long-term debt is rated "BBB" by Standard and Poor's, "Baa1" by Moody's and "7" by Duff and Phelps — all of which are considered "investment grade." The Company's commercial paper is rated "A-2," "P-2" and "1-" by those agencies. The Company's Canadian notes are rated "A" by the Canadian Bond Rating Service.

The operating results in 1985 and 1984 include Citgo for the entire year, compared with only four months in 1983.

Revenues

Revenues (net sales of products, services and merchandise, including sales by 7-Eleven stores operated by franchisees, and other income) continued to establish record highs by increasing 5.7% to $12.79 billion in 1985. A strong sales performance by the convenience retailing segment, especially 7-Eleven, was the primary cause for the record level of revenues.

Revenues *(millions)*	1985	% Gain	1984	% Gain	1983	% Gain
Net sales:						
Convenience retailing	$ 8,054.8	4.5	$ 7,707.3	13.0	$6,820.7	17.3
Gasoline refining and supply	4,140.9	6.7	3,882.0	149.7	1,554.7	186.5
Food processing and manufacturing	517.5	16.6	443.6	12.1	395.8	(.3)
Corporate	6.0	216.6	2.0	114.7	.9	(10.0)
Total sales	12,719.2	5.7	12,034.9	37.2	8,772.1	29.8
Other income	70.4	.4	70.1	112.9	32.9	29.4
TOTAL	$12,789.6	5.7	$12,105.0	37.5	$8,805.0	29.8

The convenience retailing segment accounted for 63%, 64% and 78% of total sales in 1985, 1984 and 1983. 7-Eleven volume in 1985, representing 55% of total sales, increased 8.8% to $6.98 billion, following gains of 8.1% to $6.42 billion in 1984 and 12.1% to $5.94 billion in 1983.

Merchandise sales accounted for 74.2% of total 7-Eleven sales in 1985 compared to 74.7% in 1984 and 73.6% in 1983.

7-Eleven Merchandise	1985	% Gain	1984	% Gain	1983	% Gain
Sales *(millions)*	$5,181.3	8.0	$4,797.5	9.7	$4,373.3	12.5
Number of stores	7,519	.6	7,473	2.4	7,299	1.9

More efficient use of selling space, increased advertising, new products and services, and traffic-building competitive pricing of selected items such as milk, beer, carton cigarettes and soft drinks, contributed to the gain in merchandise sales. Real growth of 4.3%, 3.7% and 3.4% in stores open more than one year, and the net addition of 46, 174 and 134 stores in 1985, 1984 and 1983, also contributed to the increase. Sales gains in 1985 reflected a slowing of the inflation rate in 7-Eleven's merchandise mix to 1.5%, down from 3.6% in 1984 and 5.1% in 1983.

Self-serve gasoline, the largest single product category in the 7-Eleven sales mix, was 25.5% of 7-Eleven sales in 1985, compared to 24.8% in 1984 and 25.5% in 1983.

7-Eleven Gasoline	1985	% Gain	1984	% Gain	1983	% Gain
Sales *(millions)*	$1,778.0	11.5	$1,594.4	5.1	$1,516.6	13.1
Gallons *(millions)*	1,602.9	10.2	1,454.4	6.8	1,361.2	17.7
Gross profit *(millions)*	$ 119.2	16.6	$ 102.2	27.0	$ 80.5	11.7
Gross profit per gallon *(cents)*	7.4	5.8	7.0	18.6	5.9	(4.8)
Number of stores	3,213	1.3	3,173	5.5	3,007	6.4

Gasoline sales increased in 1985 due to higher average gallonage per store, an increase in the number of stores selling gasoline and slightly higher average retail prices.

In addition to the 7-Eleven stores with self-serve gasoline, the Company operates 238 self-serve, high-volume retail gasoline units that also offer selected convenience items. At year-end, these units added 380 million gallons to the total retail gasoline volume, compared to 497 and 212 million gallons in 1984 and 1983.

Sales by the gasoline refining and supply segment accounted for 33% of the Company's total sales in 1985, compared to 32% in 1984 and 18% in 1983. The increase since 1982 is primarily attributed to the acquisition of Citgo.

Other income (equity earnings of pipeline companies and affiliates, interest income, area license royalties, net gains on sale of assets no longer used in the business and gain on redemption of debentures) remained relatively flat despite higher gains from the sale of assets. These increases were offset by lower gains from the repurchase of Company debentures to meet future sinking fund requirements. In 1984, other income rose 112.9% because of a full year's inclusion of equity in earnings of Citgo's pipeline companies, as well as from gains from the sale of assets, the Company's repurchase of a portion of its debentures and higher interest income. In 1983, other income rose 29.4% due to Citgo's equity in earnings of pipeline companies, which more than offset a decline in interest income.

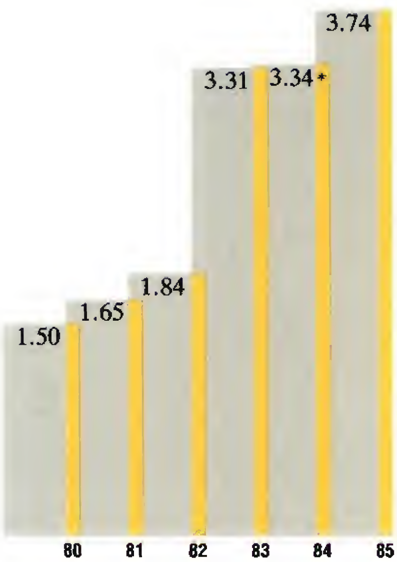
Gross Profits and Margins

Gross profits (sales less cost of goods sold) were up 13.5%, 14.2% and 13.4% compared with sales gains of 5.7%, 37.2% and 29.8% in 1985, 1984 and 1983. For the same period, gross margins (gross profits divided by sales) were:

Gross Margins *(percentage)*

QUARTERS	1985	1984	1983
First	14.53	14.15	18.66
Second	17.64	16.45	20.84
Third	18.13	16.17	19.45
Fourth	14.40	13.73	14.84
YEAR	16.25	15.13	18.18

Total Assets
(Dollars in Billions)



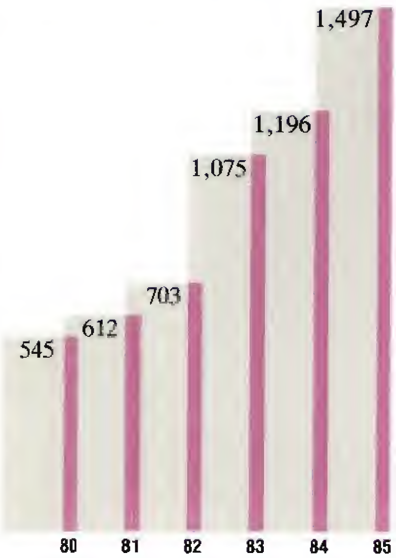
**Reflects sale of accounts receivable*

Gross margins increased in 1985 due primarily to the improved performance by Citgo as it benefited from more favorable industry conditions including higher refined product prices and lower feedstock costs. In 1984 and 1983, gross margins declined due to the addition of Citgo's low-margin, high-volume business, decreases in retail and wholesale gasoline margins and decreases in amusement game revenues.

The overall 7-Eleven gross margin decreased in 1985 as a result of decreases in the merchandise gross margins. The decreases are primarily attributed to more aggressive promotional programs and increased competitive conditions in divisions serving Houston and other Gulf Coast areas that have experienced a prolonged economic recession. The gross margin improved in 1984 as a result of higher retail gasoline and merchandise margins. In 1983, slightly lower gasoline gross margins and a decline in amusement game revenues caused a decline in the overall 7-Eleven gross margin.

Total Shareholders' Equity

(Dollars in Millions)



Selling, General and Administrative Expenses

In 1985, 1984 and 1983, selling, general and administrative expenses increased 10.6%, 16.8% and 14.9%. In the same periods, the ratios of these expenses to sales were:

Selling, General and Administrative Expenses *(percentage)*

QUARTERS	1985	1984	1983
First	14.18	12.92	17.38
Second	13.35	13.58	17.17
Third	13.95	13.60	15.31
Fourth	13.43	12.32	12.93
YEAR	13.71	13.10	15.38

Financing costs associated with the sale of accounts receivable and increased insurance expenses caused selling, general and administrative expenses as a percent of sales to increase .61 percentage points to 13.71% in 1985. The growth of retail and wholesale gasoline sales, primarily from Citgo, caused the ratio of these expenses to sales to decline in both 1984 and 1983.

Interest and Imputed Interest Expense

Interest expense, which rose 95.0% in 1984 and 92.2% in 1983, primarily due to the addition of Citgo's debt, decreased 41.6% in 1985. The decline is attributed to more favorable interest rates and reduced borrowing levels due to the sale of accounts receivable, improved operating results and the issuance of preferred stock.

Income Taxes

The effective income tax rates of 24.7% in 1985, 7.0% in 1984 and 29.0% in 1983 were below the federal statutory rate of 46% due primarily to tax benefits arising from Citgo and other tax credits. The increase in the effective rate in 1985 is attributed to the increased earnings for the year and lower investment tax credits.

Net Earnings

Net Earnings *(thousands)*

QUARTERS	1985	% Gain	1984	% Gain	1983	% Gain
First	$ 1,013	(92.9)	$ 14,250	84.6	$ 7,720	(18.9)
Second	88,713	51.7	58,460	72.2	33,956	(3.4)
Third	79,305	39.4	56,889	(5.3)	60,074	63.1
Fourth	43,504	41.9	30,653	2.1	30,018	13.1
YEAR	$212,535	32.6	$160,252	21.6	$131,768	21.9

Citgo's improved performance in 1985 contributed most of the increase in net earnings. Net earnings were higher in 1984 and 1983 due to the tax benefits arising from Citgo.

Effects of Inflation

Refer to pages 46-47, Supplementary Inflation Data (Unaudited).

(Dollars in thousands)	December 31 1985	1984
Assets		
Current assets:		
Cash and short-term investments	$ 103,476	$ 79,782
Accounts and notes receivable	264,923	168,067
Refundable income taxes	8,867	27,081
Inventories	1,050,889	992,469
Deposits and prepaid expenses	84,510	56,585
Investment in properties	61,500	69,400
Total current assets	1,574,165	1,393,384
Property, plant and equipment	2,045,351	1,815,974
Investments in affiliates	59,264	81,327
Other assets	56,764	49,087
	$3,735,544	$3,339,772
Liabilities and Shareholders' Equity		
Current liabilities:		
Commercial paper and notes payable to banks	$ 296,620	$ 122,240
Accounts payable and accrued expenses	993,357	972,676
Income taxes	51,147	14,079
Long-term debt due within one year	24,060	28,268
Total current liabilities	1,365,184	1,137,263
Deferred credits and other liabilities	187,478	150,176
Long-term debt	686,059	856,646
Commitments		
Shareholders' equity:		
Preferred stock, 5,000,000 shares authorized:		
Series A Cumulative Convertible Exchangeable Preferred Stock; $50 per share stated and liquidation value; 2,500,000 shares, being all of Series A, issued and outstanding in 1985	125,000	—
Common stock, $.01 par value, 150,000,000 shares authorized, 47,566,413 and 47,089,724 shares issued and outstanding	476	471
Additional capital	639,871	630,517
Retained earnings	731,476	564,699
Total shareholders' equity	1,496,823	1,195,687
	$3,735,544	$3,339,772

See notes to consolidated financial statements.

(Dollars in thousands, except per-share data)	1985	1984	1983
			Year ended December 31
Revenues:			
Net sales	$12,719,241	$12,034,871	$8,772,067
Other income	70,389	70,130	32,943
	12,789,630	12,105,001	8,805,010
Cost of sales and expenses:			
Cost of goods sold	10,652,762	10,214,100	7,177,147
Selling, general and administrative expenses	1,743,700	1,576,856	1,349,574
Interest expense	59,879	102,614	52,636
Imputed interest expense on capital lease obligations	19,825	19,987	20,638
Contributions to Employees' Savings and Profit Sharing Plan	31,213	19,130	19,426
	12,507,379	11,932,687	8,619,421
Earnings before income taxes	282,251	172,314	185,589
Income taxes	69,716	12,062	53,821
Net earnings	$ 212,535	$ 160,252	$ 131,768
Earnings per common share:			
Primary	$ 4.41	$ 3.41	$ 3.26
Fully diluted	$ 4.37	$ 3.38	$ 3.21

See notes to consolidated financial statements.

Consolidated Statements of Changes in Financial Position

The Southland Corporation and Subsidiaries

(Dollars in thousands)	1985	1984	1983
			Year ended December 31
Internally generated funds:			
Net earnings	$ 212,535	$ 160,252	$ 131,768
Expenses not requiring the use of cash or short-term investments:			
Depreciation and amortization	186,965	165,749	145,105
Deferred income taxes	(2,771)	30,741	15,722
Other	8,635	10,868	—
Equity in earnings of affiliates in excess of dividends received	(773)	—	(471)
	404,591	367,610	292,124
Increase in accounts payable and accrued expenses	20,681	63,874	459,959
Increase in deposits and prepaid expenses	(8,349)	(7,774)	(9,909)
Increase in inventories	(58,420)	(37,553)	(179,498)
(Increase) decrease in accounts and notes receivable	(97,556)	58,326	(287,441)
Increase (decrease) in income taxes	55,282	(21,915)	(34,577)
Increase in deferred credits and other liabilities	11,862	8,195	10,725
Increase in net current assets from acquisition of Citgo	—	—	(477,339)
Funds provided from (used in) operations	328,091	430,763	(225,956)
Funds used to pay dividends on common stock	(47,405)	(43,215)	(35,329)
Funds used to pay dividends on preferred stock	(2,150)	—	—
Net change in accumulated foreign currency translation adjustment	4,418	(2,179)	(1,206)
Net internally generated funds available (used) for investment	282,954	385,369	(262,491)
Capital investment activities:			
Acquisitions:			
Property, plant and equipment	(457,181)	(422,328)	(336,153)
Net noncurrent assets from acquisition of Citgo	—	—	(297,416)
Net noncurrent assets of other businesses acquired	(18,882)	(9,598)	(8,053)
Investment in properties	7,900	6,800	600
Investments in affiliates	22,836	2,953	(592)
Other	(887)	3,784	(8,933)
	(446,214)	(418,389)	(650,547)
Retirements of property, plant and equipment	52,931	39,476	38,166
Net funds used by capital investment activities	(393,283)	(378,913)	(612,381)
Financing activities:			
Financing acquired:			
Commercial paper and notes payable to banks	174,380	171,802	14,742
Long-term debt	59,137	290,402	264,751
Long-term debt from acquisition of Citgo	—	—	521,000
Sale of accounts receivable	700	250,000	—
Preferred stock	120,926	—	—
Common stock	12,812	5,867	276,381
	367,955	718,071	1,076,874
Discharge of long-term debt	(233,932)	(666,865)	(214,567)
Net funds provided by financing activities	134,023	51,206	862,307
Increase (decrease) in cash and short-term investments	$ 23,694	$ 57,662	$ (12,565)

See notes to consolidated financial statements.

Consolidated Statements of Shareholders' Equity

(Dollars in thousands)	1985	1984	1983
			Year ended December 31
Preferred stock:			
Balance, beginning of year	$ —	$ —	$ —
Issued	125,000	—	—
Balance, end of year	125,000	—	—
Common stock:			
Balance, beginning of year	471	469	361
Acquisition of businesses	—	—	100
Conversion of debt	2	1	3
Stock options, incentives and other	3	1	5
Balance, end of year	476	471	469
Additional capital:			
Balance, beginning of year	630,517	624,483	347,786
Acquisition of businesses	—	—	267,036
Conversion of debt	5,012	3,122	7,636
Stock options, incentives and other	4,342	2,912	2,025
Balance, end of year	639,871	630,517	624,483
Retained earnings:			
Balance, beginning of year	564,699	450,010	355,201
Net earnings	212,535	160,252	131,768
Cash dividends:			
Common stock ($1.00 per share in 1985)	(47,405)	(43,215)	(35,329)
Preferred stock ($4.00 annual rate)	(2,150)	—	—
Stock options	(621)	(169)	(424)
Foreign currency translation adjustment	4,418	(2,179)	(1,206)
Balance, end of year	731,476	564,699	450,010
Total shareholders' equity	$1,496,823	$1,195,687	$1,074,962

See notes to consolidated financial statements.

Notes to Consolidated Financial Statements
December 31, 1985

1. Accounting Policies:

Principles of Consolidation

The consolidated financial statements include the accounts of domestic and Canadian subsidiaries. Intercompany transactions are eliminated. On August 31, 1983, the Company acquired Citgo Petroleum Corporation (Citgo). The acquisition was accounted for by the purchase method and, accordingly, operations of Citgo are included in the consolidated financial statements from the date of acquisition.

Investments in affiliates are accounted for by the equity method. Accordingly, such investments are shown at cost to the Company plus equity in undistributed earnings since acquisition. Investments in affiliates consist primarily of Citgo's 6.8% to 50% equity interests in pipeline companies and, for 1984, amounts invested in a wholly owned United Kingdom subsidiary engaged in the operation of retail stores that was sold in August 1985. Equity in earnings of affiliates is included in other income and is recorded net of amortization of the intangibles that arose on the acquisition (straight-line over 40 years) and, as to foreign affiliates, net of foreign income taxes and a provision for United States federal income taxes. At December 31, 1985, substantially all of the Company's equity in earnings of affiliates has been received in the form of dividends, and its investments in affiliates exceeded its equity in the underlying net assets by $36,008,000.

Financial information provided by the pipeline companies is summarized as follows:

	December 31	
(000s omitted)	1985	1984
Summary of financial position:		
Current assets	$ 100,544	$ 112,075
Noncurrent assets	1,195,732	1,229,686
	$1,296,276	$1,341,761
Current liabilities	$ 188,664	$ 210,016
Noncurrent liabilities	1,009,742	1,032,475
Shareholders' equity	97,870	99,270
	$1,296,276	$1,341,761
Company investment in pipeline companies	$ 48,032	$ 50,512

	Year ended December 31		Four months ended December 31
(000s omitted)	1985	1984	1983
Summary of operating results:			
Revenues	$690,159	$681,501	$231,154
Gross profit	406,597	401,604	135,823
Net earnings	175,009	170,536	60,611
Company equity in net earnings	22,603	21,533	7,446
Dividends received	22,609	22,651	7,676

Revenues

Net sales are comprised of sales of products, services and merchandise, including sales by stores operated by franchisees of $2,287,554,000, $2,042,549,000 and $1,769,970,000 for the years ended December 31, 1985, 1984 and 1983. There is no significant difference in the profitability of Company-operated and franchisee-operated stores.

Sales by stores operated under domestic and foreign area license agreements are not included. All fees or royalties arising from such agreements are included in other income. Initial fees, which have been immaterial, are recognized when the services required under the agreements are performed.

Citgo engages in crude oil trading to facilitate the supply of crude oil to its refinery. Only the net result of such trading is recorded in the accounts.

Other income is primarily comprised of equity in earnings of affiliates, interest on short-term investments and area license royalties.

Cost of Goods Sold
Cost of goods sold includes, for the convenience retailing segment, buying and occupancy expenses.

During 1985 and 1984, Citgo purchased, at average posted prices, approximately $472 and $716 million in crude oil and other products for use at its refinery from Occidental Petroleum Corporation, a shareholder of the Company.

Inventories
Inventories are stated at the lower of cost or market, which, as to merchandise in stores, is determined by the retail inventory method. Cost is determined using the last-in, first-out (LIFO) method for substantially all inventories (including gasoline) of the convenience retailing segment and for refined products of the gasoline refining and supply segment, and the first-in, first-out (FIFO) method for all other inventories.

The cost of refined products inventory and other manufactured or processed finished goods inventory includes the costs of purchased materials, direct labor and manufacturing overhead.

Investment in Properties
Investment in properties includes land, buildings and equipment either to be sold for cash and leased back or to be mortgaged, as well as closed stores held for sale. The Company expects that cash will be realized for these properties within a 12-month period. Working capital is used in the acquisition, construction and carrying of these assets.

Depreciation and Amortization
Depreciation of plant and equipment and amortization of capital leases are based upon the estimated useful lives of these assets using the straight-line method. Amortization of improvements to leased properties is based upon the remaining terms of the leases or the estimated useful lives of such improvements, whichever is shorter.

Excise Taxes
Excise taxes of $341,834,000, $373,580,000 and $259,947,000 collected from customers on retail gasoline sales are included in net sales and cost of goods sold for the years ended December 31, 1985, 1984 and 1983.

Income Taxes and Investment Tax Credits
Income taxes are the estimated amount of federal and state income taxes on earnings reported in the consolidated statements of earnings. Deferred taxes and deferred tax benefits are provided for and are a result of timing differences between financial and tax reporting.

Investment tax credits are recorded as a reduction of income taxes in the year the related assets are placed in service.

Leases
Capital leases are recorded at the inception of the lease at the lower of the discounted present value of future lease payments or the fair value of the property.

For closed leased stores, provision is made on a current basis if anticipated expenses are in excess of expected sublease rentals.

2. Cash and Short-Term Investments:

Cash and short-term investments include temporary cash investments of $54,358,000 and $72,943,000 at December 31, 1985 and 1984, stated at cost, which approximates market.

3. Accounts and Notes Receivable:

	December 31	
(000s omitted)	1985	1984
Trade accounts and notes receivable	$243,636	$145,093
Franchisee accounts receivable	33,952	34,936
	277,588	180,029
Allowance for doubtful accounts	(12,665)	(11,962)
	$264,923	$168,067

On December 28, 1984, the Company sold $250 million of accounts receivable under an agreement in which the purchaser will reinvest the proceeds collected in new receivables for a period of five years. Throughout 1985, the rollover of proceeds collected and reinvested in new accounts receivable aggregated $4.6 billion. As of December 31, 1985, $251 million of receivables were outstanding under the agreement. The Company is contingently liable for the collection of up to $25.5 million of these receivables; however, management believes that the allowance for doubtful accounts will be adequate and no additional liabilities will accrue.

4. Inventories:

	December 31	
(000s omitted)	1985	1984
Retail and finished goods	$ 329,702	$255,902
Refined product (excluding product at stores)	561,296	526,722
Crude oil	112,353	166,332
Other	47,538	43,513
	$1,050,889	$992,469

At December 31, 1985 and 1984, inventories stated on the LIFO basis (for financial statement purposes) were approximately $757,044,000 and $673,657,000, which is less than replacement cost by approximately $60,527,000 and $59,959,000.

As a result of the carryover of historical tax basis for Citgo refined product inventories acquired at August 31, 1983, the book LIFO basis of these inventories exceeds the tax LIFO basis by $229 million. The Company expects the levels of refined product inventories required for normal operations always to exceed the amounts acquired on August 31, 1983, and included in the book LIFO basis.

5. Property, Plant and Equipment:

	December 31	
(000s omitted)	1985	1984
Cost:		
Land	$ 289,329	$ 226,669
Buildings and leaseholds	1,116,753	955,905
Machinery and equipment	1,051,297	1,004,875
Vehicles	119,848	126,594
Construction in process	132,260	96,374
Property held for future Cityplace development	118,694	113,146
Cityplace construction in process	115,046	63,943
	2,943,227	2,587,506
Accumulated depreciation and amortization	(897,876)	(771,532)
	$2,045,351	$1,815,974

Interest incurred to finance the construction or development of properties, which has been added to the cost of the related assets, was $11,328,000 in 1985, $7,776,000 in 1984 and $5,557,000 in 1983.

In 1984, the Company commenced construction of a new corporate headquarters tower within Cityplace Center, the first stage of the Company's Cityplace commercial real estate development in Dallas, Texas. Construction costs to complete Cityplace Center, which will include the headquarters tower and, for rental, a duplicate tower and office complex, are expected to approximate $650 million.

6. Accounts Payable and Accrued Expenses:

(000s omitted)	December 31 1985	1984
Trade accounts payable	$637,882	$637,541
Accrued payroll	94,660	85,314
Accrued taxes	83,443	69,224
Other	177,372	180,597
	$993,357	$972,676

7. Debt:

December 31, 1985

(000s omitted)	Amount outstanding	Due within one year	Balance included in long-term debt
Commercial paper and notes payable to banks	$150,000	$ —	$150,000
Citgo revolving loan	70,000	—	70,000
Real estate, equipment and other notes with a weighted average interest rate of 9.07% (mature 1986 to 2011)	108,754	11,162	97,592
Citgo industrial development revenue bonds	29,200	—	29,200
5% convertible subordinated debentures due 1987	3,287	—	3,287
8⅜% sinking fund debentures due 2002	24,351	—	24,351
9⅛% sinking fund debentures due 2003	42,305	—	42,305
9½% sinking fund debentures due 2004	60,907	—	60,907
12% Canadian notes due 1992	35,933	—	35,933
Capital lease obligations	185,382	12,898	172,484
	$710,119	$24,060	$686,059

Commercial paper and notes payable to banks of $150 million have been classified as long-term debt because the Company intends to maintain at least this amount of such debt for a minimum of one year or intends to refinance the debt on a long-term basis and has the availability of such refinancing because of the existence of the lines of credit. The Company intends such a refinancing when market conditions become advantageous. The average interest rate on commercial paper and notes payable to banks outstanding at December 31, 1985, is 8.28%, which is less than the interest rates available at that date under the revolving credit agreements.

Citgo has a revolving credit agreement with a syndicate of commercial banks providing for a line of credit of $375 million through December 31, 1992, with interest rate options based upon the certificate of deposit loan rate, the London interbank borrowing rate (both of which generally are less than the prime interest rate) or the prime rate, payable at least quarterly. The agreement provides for a commitment fee on unadvanced funds of ¼% per annum, payable quarterly. No compensating balances are required. The agreement provides for 20 equal quarterly payments of principal, beginning March 31, 1988. At December 31, 1985, $70 million is outstanding under this agreement. Borrowings under this agreement are collateralized by Citgo's inventories and accounts receivable, which aggregate $691,063,000 at December 31, 1985.

Property, plant and equipment with a carrying value of approximately $95 million at December 31, 1985, was mortgaged under real estate, equipment and other notes. Lenders to certain wholly owned real estate subsidiaries hold pledges of the shares of those subsidiaries as additional collateral.

The Citgo industrial development revenue bonds bear floating market interest rates (8⅝% at December 31, 1985). Bonds aggregating $17,400,000 are due in 2004, with the remainder due in 2007.

The 5% convertible debentures may, at the option of the holders, be converted at any time prior to maturity into the Company's common stock. The present conversion ratio is 45.19 shares for each $1,000 of principal. At December 31, 1985, there were 148,539 shares reserved for the conversion of these debentures.

The 12% Canadian notes due 1992 are redeemable at the option of the Company from July 1990 to July 1991 at 101½% of the principal amount and after July 25, 1991, until maturity at 100¾% of principal. Payments of interest and principal are denominated in Canadian dollars.

The Company has a revolving credit agreement with a syndicate of commercial banks providing for a line of credit of $200 million through March 1988. The agreement provides for 16 equal quarterly payments of principal plus accrued interest beginning March 31, 1988, and provides for a commitment fee on unadvanced funds of ¼% per annum. The Company has another revolving credit agreement with a syndicate of European and Japanese banks providing for a line of credit of $200 million through February 21, 1988. The agreement provides for eight equal quarterly payments of principal plus accrued interest beginning March 31, 1988, and provides for a commitment fee on unadvanced funds of ⅛% per annum. Both agreements include interest rate options based upon the certificate of deposit loan rate, Eurodollar loan rate (both of which generally are less than the prime interest rate) or the prime rate. Neither agreement requires the maintenance of compensating balances. No loans are outstanding under these agreements at December 31, 1985.

During 1984, the Company entered into currency exchange agreements with two multinational financial institutions that converted $75 million of commercial paper borrowings into Japanese yen equivalents bearing interest at 7.7% on a quarterly payment basis, payable in Japanese yen for seven to 10 years. The Company has hedged these Japanese yen borrowings by designating its future royalty receipts from its Japanese area licensee to service interest and principal yen payments, thus offsetting the impact of exchange rate fluctuations. Accordingly, no foreign currency exchange rate gain or loss is recognized on these yen borrowings. The Company also has interest rate exchange agreements which fix the interest rate on $150 million of floating rate debt at 11.7% on a semiannual payment basis until 1987.

As of December 31, 1985, long-term debt (which includes capital lease obligations and sinking fund requirements) scheduled maturities are as follows (000s omitted):

1986	$ 24,060
1987	27,767
1988	76,829
1989	79,565
1990	80,455
Thereafter	421,443
	$710,119

8. Stock Options, Key Employees Incentive Plan and Preferred Stock:

Stock Options

The Employees Stock Option Plan (the Plan), adopted in 1977 and amended in 1983, provides for the granting of options to key employees and officers of the Company. The options are generally granted at the fair market value of the shares on the date of grant.

Options granted under Part A of the Plan expire 10 years from date of grant and are exercisable ratably over that period on a cumulative basis. Options granted under Part B of the Plan expire at least two years, and not more than 10 years, from date of grant and are exercisable ratably over the period specified in the option on a cumulative basis.

Options granted under Part C of the Plan qualify as incentive stock options under Section 422A of the Internal Revenue Code. These options will expire at least two years, and not more than 10 years, from date of grant and are exercisable ratably in the sequence granted over the period specified in the option.

Options granted under Parts A and B of the Plan may include the right of the optionholder to receive, upon exercise of an option, a cash payment equal to the difference between the purchase price and the market price on the date of exercise. All applicable options granted under the Plan, through December 31, 1985, include such a right.

At December 31, 1985, there were options outstanding to acquire 1,955,518 shares at prices from $12.73 to $36.63 per share, with an average price of $32.79 per share, of which 404,646 were exercisable. Options outstanding will expire from 1987 to 1993. During the year ended December 31, 1985, options for 153,699 shares were exercised at $12.73 to $36.63 per share. At December 31, 1985, 3,547,477 shares were authorized for future issuance under this plan.

Key Employees Incentive Plan
At December 31, 1985, 128,930 shares were authorized for issuance pursuant to a key employees incentive plan, of which 42,171 shares will be issued in 1986. In 1985 and 1983, 49,562 and 28,344 shares were issued under the plan. No shares were issued in 1984.

Preferred Stock
On August 29, 1985, the Company issued 2,500,000 shares of Series A Cumulative Convertible Exchangeable Preferred Stock with a stated and liquidation value of $50 per share. Dividends are cumulative at an annual rate of $4 per share and are payable quarterly. Under normal circumstances, the preferred stock will have no voting rights.

The stock is redeemable at any time on or after August 15, 1988, in whole or in part, at the option of the Company at $52.80 per share, declining to $50 per share on August 15, 1995. Unredeemed shares are convertible at the option of the holder at any time into common stock, $.01 par value, at the rate of 1.1723 shares for each share of preferred stock. At December 31, 1985, 2,930,750 shares of common stock were reserved for such conversions.

The stock also is exchangeable in whole, at the option of the Company, beginning August 15, 1988, for 8% convertible subordinated debentures at the rate of $50 principal amount of debenture for each share of preferred stock. Each debenture will be convertible at any time prior to August 15, 2015, at the option of the holder, into 1.1723 shares of common stock.

If additional preferred stock is issued, it will have such rights, powers and preferences as determined by the Company's Board of Directors.

9. Employee Benefit Plans:

Employees' Savings and Profit Sharing Plan
Effective January 1, 1949, the Company adopted The Southland Corporation Employees' Savings and Profit Sharing Plan (Profit Sharing) for the purpose of providing retirement benefits for eligible employees.

Contributions to Profit Sharing are made by both the participants and the Company. The Company contributes approximately 10% of its net earnings, before contribution to Profit Sharing, contribution to the ESOP and federal income taxes. The Company contribution is allocated to the participants on the basis of their individual contribution, years of participation in Profit Sharing and age.

Employee Stock Ownership Plan
Effective January 1, 1983, the Company adopted the Southland Employee Stock Ownership Plan (the ESOP) for eligible employees. Contributions to the ESOP, which totaled $3,020,000, $2,841,000 and $2,183,000 for 1985, 1984 and 1983, can be made by the Company in either cash or shares of common stock and are limited to 0.5% of the aggregate compensation of the participants. The Company contribution is allocated to the participants on an equal basis and results in a federal tax credit of equal amount.

Citgo Benefit Plans
Citgo has a thrift plan and a pension plan for its hourly employees. Contributions to the thrift plan are subject to sufficient accumulated taxable earnings and profits and are based on employee contributions and years of service. Citgo makes annual contributions to the pension plan to fund costs in the year accrued.

A comparison of accumulated benefits and net assets for the pension plan follows:

(000s omitted)	January 1, 1985	January 1, 1984
Actuarial present value of accumulated benefits:		
Vested	$22,617	$21,240
Nonvested	2,174	2,191
	$24,791	$23,431
Net assets available for benefits	$40,874	$34,900

The weighted average assumed rate of return used in determining the actuarial present value of accumulated benefits was 9%.

Citgo expensed $3,081,000, $4,367,000 and $2,299,000 for its pension and thrift plans for the years ended December 31, 1985 and 1984, and the four months ended December 31, 1983, which includes the amortization of pension plan prior service costs over 20 years.

Post-Retirement Insurance Benefits
Under a plan that covers both active and retired employees, the Company provides certain health care and life insurance benefits for retirees through a trust that is funded partially by their payments and the balance by the Company. Substantially all employees may become eligible for these retirement benefits if they reach normal retirement age or qualify for the Company's early retirement plan. The cost to the Company of retiree health care and life insurance benefits is recognized as expense as claims are incurred and was $2,113,000 and $1,341,000 in 1985 and 1984.

10. Leases:

Certain of the property, plant and equipment used in the Company's business is leased. Generally, real estate leases are for primary terms of from 14 to 20 years with options to renew for additional periods, and equipment leases are for terms of from five to 10 years. The leases do not contain restrictions that have a material effect on the Company's operations.

The composition of capital leases reflected as property, plant and equipment in the consolidated balance sheets is as follows:

	December 31	
(000s omitted)	1985	1984
Buildings	$262,187	$252,218
Equipment	52,087	61,417
	314,274	313,635
Accumulated amortization	(181,850)	(174,589)
	$132,424	$139,046

The present value of future minimum lease payments for capital lease obligations is reflected in the consolidated balance sheets as long-term debt. The amount representing imputed interest necessary to reduce net minimum lease payments to present value has been calculated generally at the Company's incremental borrowing rate at the inception of each lease.

Future minimum lease payments for years ending December 31 are as follows:

(000s omitted)	Capital leases	Operating leases
1986	$ 31,922	$ 133,466
1987	29,828	112,863
1988	28,686	102,773
1989	27,713	88,836
1990	26,950	85,286
1991 and thereafter	202,878	661,120
Future minimum lease payments	347,977	$1,184,344
Estimated executory costs	(5,595)	
Amount representing imputed interest	(157,000)	
Present value of future minimum lease payments	$185,382	

Minimum sublease rentals to be received in the future, which are not included above as offsets to future payments, total $17,582,000 for capital leases and $14,704,000 for operating leases.

Rent expense on operating leases in the years ended December 31, 1985, 1984 and 1983, totaled $126,018,622, $101,706,000 and $81,992,000, including contingent rentals of $3,783,000, $3,802,000 and $3,026,000, reduced by sublease rentals of $3,875,000, $2,859,000 and $1,966,000. Contingent rent expense on capital leases in the years ended December 31, 1985, 1984 and 1983, was $9,262,000, $9,308,000 and $7,409,000.

Leases With Profit Sharing

During 1984 and 1983, Profit Sharing purchased 31 and 129 7-Eleven or Chief Auto Parts stores from the Company for $13,307,000 and $41,372,000, which include the Company's direct and indirect costs. The stores were simultaneously leased to the Company at annual rentals approximating market rates. No stores were purchased during 1985. At December 31, 1985, Profit Sharing owned 821 stores leased to the Company under capital leases (net unamortized amount — $33,114,000) and 609 stores leased to the Company under operating leases.

11. Income Taxes:

Provisions for income taxes for the years ended December 31 are as follows:

(000s omitted)	1985	1984	1983
Currently payable (refundable):			
Federal	$67,980	$(25,169)	$27,175
Canadian	2,107	3,464	2,700
State	2,400	3,026	8,224
	72,487	(18,679)	38,099
Deferred	(2,771)	30,741	15,722
	$69,716	$ 12,062	$53,821

Reconciliations of the Company's effective tax rate and the federal statutory rate for the years ended December 31 are as follows:

	1985	1984	1983
Federal statutory rate	46.0%	46.0%	46.0%
Investment tax credits	(5.5)	(14.7)	(11.9)
State income taxes net of federal income tax benefit	.5	.9	2.4
Depreciation	(12.5)	(20.1)	(4.5)
Dividends received deduction	(3.2)	(4.4)	(1.5)
Other	(.6)	(.7)	(1.5)
	24.7%	7.0%	29.0%

The provisions for deferred income taxes (benefits) for the years ended December 31 are as follows:

(000s omitted)	1985	1984	1983
Use of accelerated depreciation for tax purposes	$42,529	$37,465	$ 9,849
Insurance accruals not deductible for tax purposes	(20,002)	(6,455)	3,695
Write-down of inventories to market not deductible for tax purposes	(17,480)	—	—
Other	(7,818)	(269)	2,178
	$(2,771)	$30,741	$15,722

Deferred federal income taxes of $94,389,000 and $68,949,000 at December 31, 1985 and 1984, are included in deferred credits and other liabilities. Net deferred tax benefits of $38,201,000 and $9,990,000 at December 31, 1985 and 1984, are included in deposits and prepaid expenses.

12. Earnings Per Common Share:

Primary earnings per common share are based on net earnings reduced by preferred stock dividends divided by the average number of shares outstanding during each year. Earnings per share assuming full dilution are based on net earnings divided by the sum of (a) shares used in computing primary earnings per share, (b) average shares issuable upon conversion of preferred stock, (c) shares issuable upon conversion of convertible debentures at the stated conversion rates (related interest requirements eliminated), (d) shares issuable on the exercise of stock options after reduction for shares assumed to have been purchased with the proceeds and (e) average shares issuable under the key employees incentive plan.

13. Segment Information:

Convenience retailing includes all convenience, grocery and auto parts stores, retail gasoline outlets, and distribution centers (which derive the majority of their revenues and operating profits from support of these stores). Gasoline refining and supply includes the Citgo refinery, investments in pipeline companies (except equity in their earnings, which is shown separately) and a lubricants refinery, and related wholesale, marketing and transportation facilities, as well as the former Gasoline Supply Division, which constituted the entirety of the segment through August 31, 1983, the date of the acquisition of Citgo, and is now part of Citgo. Food processing and manufacturing includes milk, ice cream and other food processing and distribution operations, and the ice, Food Labs and Tidel Systems divisions. Interest expense is not allocated to segments. Corporate items reflect revenues, expenses and assets not allocable to segments.

Intersegment sales are accounted for on a cost-plus-markup basis. Expenses directly identifiable with a segment and certain allocated income and expenses are used to determine operating profit by segment.

Management's Responsibility for Financial Reporting

The consolidated financial statements of The Southland Corporation and subsidiaries, as well as other financial information contained in this report, were prepared by management, which is responsible for their integrity and objectivity.

The Company's financial position and results of operations are presented in conformity with generally accepted accounting principles and, where appropriate, reflect estimates based on judgments of management. The Company has designed and implemented accounting and reporting systems and controls to provide reasonable assurance that transactions are accurately reflected in the books and records, assets are protected, established policies and procedures are followed, and the Company's financial position and results of operations are presented fairly. Accounting and reporting controls are monitored through an extensive program of internal audits by a professional staff of Company auditors that coordinates its activities with the Company's independent certified public accountants.

Touche Ross & Co. is engaged to examine the consolidated financial statements and issue its report thereon. Its examination is conducted in accordance with generally accepted auditing standards, including a review of internal controls and such tests of the accounting records as it considers necessary.

The Board of Directors, assisted by its Audit Committee of four non-employee directors, is responsible for assuring that management fulfills its responsibilities in the preparation of the financial statements and for recommending to shareholders the engagement of the independent certified public accountants, with whom the Committee reviews the scope of the audit and the accounting principles to be applied in financial reporting. The Committee meets as necessary, but at least three times a year. Touche Ross & Co. and the Company's internal auditors have direct access to the Committee — with or without the presence of management — to discuss any appropriate matter.

Clark J. Matthews, II

Clark J. Matthews, II
Senior Executive Vice President
and Chief Financial Officer

Independent Auditors' Report

Board of Directors and Shareholders
The Southland Corporation
Dallas, Texas

We have examined the consolidated balance sheets of The Southland Corporation and subsidiaries as of December 31, 1985 and 1984, and the related consolidated statements of earnings, shareholders' equity and changes in financial position for each of the three years in the period ended December 31, 1985. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the consolidated financial statements referred to above present fairly the financial position of The Southland Corporation and subsidiaries at December 31, 1985 and 1984, and the results of their operations and the changes in their financial position for each of the three years in the period ended December 31, 1985, in conformity with generally accepted accounting principles applied on a consistent basis.

Touche Ross & Co

Dallas, Texas
February 26, 1986

Certified Public Accountants

Introduction

Under generally accepted accounting principles, financial statements traditionally have been prepared on the basis of historical cost. Over time, inflation distorts this accounting measurement. The supplementary information below attempts to show the impact of inflation on the Company's financial statements.

Method of Measuring the Effects of Inflation

Current cost reporting provides information with respect to changes in specific prices (current costs) by adjusting historical cost to the cost which is currently required to purchase inventories and property, plant and equipment. Over time, current cost increases at a rate different from the Consumer Price Index for all Urban Consumers (CPI-U). Current cost of property, plant and equipment and related depreciation and amortization expense were determined by application of appropriate published and internally developed indexes. The last-in, first-out (LIFO) method is used to determine the cost of the majority of inventories. Because of the rapid turnover of inventories and the use of LIFO, the cost of goods sold as shown in the historical cost financial statements approximates current cost. Current cost of inventories was estimated using first-in, first-out valuations adjusted for price changes through the end of the year.

Management's Comments

The following schedules compare financial data reported on a historical cost basis with data adjusted for current costs.

Revenues (in millions of dollars) for 1985 were $12,789.6 and for 1981, expressed in average 1985 dollars, were $6,782.4, resulting in an average annual compound real sales growth rate from 1981 to 1985 of 15.4%.

Net earnings determined under the current cost method are lower than earnings determined under the historical cost method. This decline results principally from the higher depreciation and amortization expense arising from significant inflationary increases in the cost of property, plant and equipment. The impact of inflation on inventories is not significant to earnings since earnings are based primarily on LIFO, which approximates the results obtained under the current cost method.

Present tax laws do not allow deductions for depreciation adjusted for the effect of inflation. Therefore, the Company's tax rate based on data adjusted for the impact of inflation can be in excess of the statutory rate. As shown in the following statement of earnings, the effective tax rate rises from 24.7% based on historical cost to 35.3% based on the current cost method.

The reduction in net earnings, discussed above, is partially offset by the unrealized gain from the decline in purchasing power of net amounts owed (monetary liabilities in excess of monetary assets). Since the monetary liabilities at year-end were larger than the monetary assets, a gain is shown. This gain represents the change in the amount of purchasing power required at year-end to pay these net liabilities compared to the higher amount that would have been required to pay them at the end of the preceding year.

Supplementary Information — The Impact of General Inflation and Specific Price Changes on Selected Financial Data

(Dollars in millions)	Year ended December 31, 1985 As reported in financial statements	Adjusted for current costs
Revenues	$12,789.6	$12,789.6
Cost of sales and expenses:		
Cost of goods sold, exclusive of depreciation and amortization	10,502.0	10,504.5
Depreciation and amortization	186.9	269.2
Interest expense, including imputed interest expense on capital lease obligations	79.7	79.7
Other operating expenses	1,738.8	1,738.8
	12,507.4	12,592.2
Earnings before income taxes	282.2	197.4
Income taxes	69.7	69.7
Net earnings	$ 212.5	$ 127.7
Effective tax rate	24.7%	35.3%
Unrealized gain from decline in purchasing power of net amounts owed	—	$ 67.9
Increase in current cost of inventories and property, plant and equipment held during the year	—	$ 220.4
Effect of increase in general inflation	—	138.4
Excess of increase in current costs over increase in general inflation	—	$ 82.0

The current costs of inventories and property, plant and equipment, net of accumulated depreciation and amortization, at December 31, 1985, and corresponding historical cost amounts, were as follows:

(Dollars in millions)	Historical Cost	Current Cost
Inventories	$1,050.9	$1,136.0
Property, plant and equipment — net	2,045.4	2,776.9

Five-Year Comparison of Selected Supplementary Financial Data Adjusted for Effects of Changing Prices *(In average 1985 dollars)*

(Dollars in millions, except per-share data)	Year ended December 31 1985	1984	1983	1982	1981
Revenues	$12,789.6	$12,537.1	$9,507.7	$7,559.0	$6,782.4
Historical cost information adjusted for current costs:					
Net earnings	127.7	90.4	59.2	50.5	37.9
Primary earnings per share	2.62	1.92	1.47	1.41	1.07
Net assets at year-end	2,342.3	1,960.0	1,880.1	1,447.2	1,440.7
Excess (decrement) of increase in current costs over increase in general inflation	82.0	14.8	75.6	(41.3)	(8.7)
Unrealized gain from decline in purchasing power of net amounts owed	67.9	71.6	37.8	33.5	71.3
Cash dividends per common share	1.00	.95	.94	.86	.83
Market price per common share at year-end	44	28⅛	34⅝	29	24⅝
Average CPI-U	322.2	311.1	298.4	289.1	272.4

John P. Thompson (1948)
Chairman of the Board and Chief Executive Officer

Jere W. Thompson (1961)
President

William W. Atwell[1,2,3] (1976)
Investments

J. Y. Ballard (1937)
Investments

Frank L. Carney (1982)
Owner, Carney Enterprises

Walton Grayson, III (1962)
Executive Vice President, Administration and Services

Dr. Armand Hammer (1983)
Chairman and Chief Executive Officer, Occidental Petroleum Corporation

Joseph S. Hardin (1977)
Retired Executive Vice President; President and Director, Hargoro, Inc.

Mark L. Lemmon, M.D.[1,2] (1977)
Plastic and Reconstructive Surgeon

Leo E. Linbeck, Jr.[1,3] (1982)
Chairman and Chief Executive Officer, Linbeck Construction Corporation

Clark J. Matthews, II (1981)
Senior Executive Vice President and Chief Financial Officer

Walter M. Mischer, Jr.[3] (1982)
President, The Mischer Corporation

Alan C. Schoellkopf[1,2] (1979)
Vice President, Rotan Mosle Inc.

Joe C. (Jodie) Thompson, Jr. (1979)
Senior Executive Vice President, Retail

(Date indicates year first elected)
[1]Members of the Audit Committee
[2]Members of the Nominating Committee
[3]Members of the Compensation and Benefits Committee

Officers

Senior Officers

John P. Thompson
Chairman of the Board and Chief Executive Officer

Jere W. Thompson
President

Clark J. Matthews, II
Senior Executive Vice President and Chief Financial Officer

Joe C. (Jodie) Thompson, Jr.
Senior Executive Vice President, Retail

S. R. Dole
Executive Vice President, 7-Eleven Stores

Walton Grayson, III
Executive Vice President, Administration and Services

James W. Parker
Executive Vice President, Manufacturing and Distribution

Ronald E. Hall
Senior Vice President, and President and Chief Executive Officer, Citgo Petroleum Corporation

Sam J. Susser
Senior Vice President

Operating Officers

C. O. Beshears
Vice President, Dairies Group

Donald L. Burnside
Vice President, Western Stores Region

Adrian O. Evans
Vice President, Central Stores Region

Kenneth J. Hughes
Vice President, Special Operations (Effective January 22, 1986)

Frank L. Kitchen
Vice President, Eastern Stores Region

James R. Lynch
Vice President, Southeastern Stores Region

Hugh G. Robinson
Vice President, Cityplace Project, and President, Cityplace Development Corporation

Richard A. Turchi
Vice President, International Operations

Bill M. Wootton
Vice President, Specialty Retail

Staff Officers

Rulon R. Brough
Vice President, EDP Facilities Planning

Frank J. Gangi
Vice President and Treasurer

Vaughn R. Heady
Vice President (Retired June 30, 1985, after 37 years of service)

David Karney
Vice President, Management Information Services

Allen Liles
Vice President, Public Relations

Frank E. McKeown
Vice President, Marketing-Retail

P. Eugene Pender
Vice President and Controller

L. Mark Rigg
Vice President, Human Resources

John H. Rodgers
Vice President and General Counsel

Kenneth M. Slauth
Vice President, Development

Henry T. Stanley, Jr.
Vice President, Investor Relations

R G Smith
Secretary

Corporate Headquarters:

The Southland Corporation
P.O. Box 719, Dallas, Texas 75221
(214) 828-7011 (also see numbers below)

Shareholder Contacts:

Corporate and Financial Information — write the Investor Relations Department at the above address, or telephone (214) 828-7217.

Shareholder Services (shareholder account, dividend reinvestment or other shareholder services) — write the Corporate Secretary at the above address, or telephone (214) 828-7300.

Annual Meeting:

The Annual Meeting of the Company will be held at 10 a.m. Wednesday, May 7, 1986, in the North Wing Auditorium of the Corporate Office, 2828 North Haskell Avenue, Dallas, Texas. All shareholders are cordially invited to attend.

Securities Listed:

New York Stock Exchange (SLC):
- Common Stock
- Series A Cumulative Convertible Exchangeable Preferred Stock
- 8⅜% Sinking Fund Debentures
- 9⅜% Sinking Fund Debentures
- 9½% Sinking Fund Debentures

Luxembourg Stock Exchange:
- 5% Convertible Subordinated Debentures
- 12% Canadian Notes

Transfer Agent and Registrar:

Common Stock
Series A Cumulative Convertible Exchangeable Preferred Stock
8⅜% Sinking Fund Debentures
9⅜% Sinking Fund Debentures
9½% Sinking Fund Debentures

MBank Dallas, N.A.
P.O. Box 225415
Dallas, TX 75265
Dallas: 749-5941
Texas: (800) 492-9734
Outside Texas: (800) 527-7844

Auditors:

Touche Ross & Co.
2001 Bryan Tower, Suite 2400
Dallas, TX 75201

Dividend Reinvestment Plan:

This plan provides a simple, convenient and inexpensive way for shareholders to invest cash dividends and additional cash deposits in Southland stock. For further information, please write the Corporate Secretary at the Corporate Headquarters address.

Form 10-K:

Shareholders may obtain a copy, exclusive of exhibits, of the Form 10-K Annual Report for the year ended December 31, 1985, as filed with the Securities and Exchange Commission, by writing to the Investor Relations Department at the Corporate Headquarters address.

Market Data:

Southland's common stock is traded under the symbol SLC on the New York, Pacific, Boston and Philadelphia Stock Exchanges. The following price/earnings ratios are based upon primary earnings per share for the four preceding quarters.

Quarters	Price Range		Price/Earnings Ratios	
1985	High	Low	High	Low
First	33½	24¾	9.8	7.3
Second	37⅞	28¾	11.9	9.2
Third	39½	33⅝	10.5	8.9
Fourth	50	35⅝	11.9	8.5
1984				
First	35¾	31	11.0	9.6
Second	36½	26⅝	11.0	8.0
Third	32⅞	23	9.0	6.3
Fourth	32¾	25	9.6	7.4
1983				
First	31⅝	25⅛	10.5	8.3
Second	48¼	29⅞	16.3	10.1
Third	46	38½	16.0	13.4
Fourth	44¾	29½	13.4	8.9

The Southland Corporation

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